RESULTS OF THE INTERNAL REVENUE SERVICE'S FISCAL YEAR 1999 FINANCIAL STATEMENT AUDIT

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION, AND TECHNOLOGY

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

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RESULTS OF THE INTERNAL REVENUE SERVICE'S FISCAL YEAR 1999 FINANCIAL STATEMENT AUDIT

TUESDAY, FEBRUARY 29, 2000

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION, AND TECHNOLOGY,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2247, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn, Biggert, and Turner.

Staff present: J. Russell George, staff director and chief counsel; Louise DiBenedetto, GAO detailee; Bonnie Heald, director of communications; Bryan Sisk, clerk; Trey Henderson, minority counsel; and Ellen Rayner, minority chief clerk.

Mr. HORN. The Subcommittee on Government Management, Information, and Technology will come to order.

Unfortunately, it is an accepted fact that the Federal Government's financial systems are obsolete and ineffective. Most Federal agencies cannot produce complete, consistent and reliable financial information on a timely basis. These problems have been identified by the General Accounting Office and Inspectors General during the audits of the Federal agencies' annual financial statements.

Attempting to correct these problems, Congress passed several major legislative reforms, including the Chief Financial Officer's Act of 1990, the Government Management Reform Act of 1994, and the Federal Financial Management Improvement Act of 1996. These were all bipartisan laws and they were enacted to ensure that Federal agencies produce timely and accurate information, which they need to manage their operations and measure the full cost and financial performance of their programs.

Unfortunately, our previous subcommittee hearings have demonstrated that this important goal is a long way from being met. For the past 2 years, this subcommittee has held oversight hearings on the actions or lack of actions being taken by Federal departments and agencies to resolve their long-standing financial management problems. Again, this year, the Government Management Subcommittee will conduct a series of hearings examining financial audits of selected departments and agencies. Today's hearing begins this series.

The auditing process can determine whether entities, private or public, are managing their money efficiently and whether they can produce timely, accurate and useful management information, particularly financial management information. At today's hearings, we will learn the results of the General Accounting Office's audit of the Internal Revenue Service for fiscal year 1999. The results of this audit and related financial management practices at the Internal Revenue Service are not only important, but they are important to Congress and its functioning, they are important to the President, and they are important to all of the taxpayers who depend on the agency to accurately collect the taxes the Treasury is due. Further, many Americans rely on the accurate refund of overpayments and expect the agency to pursue those who fail to pay the taxes that they owe.

Last year alone, the IRS collected a total of $1.8 trillion in Federal tax revenue and paid out $151 billion in tax refunds. Prior reports by the General Accounting Office have been alarming. Serious problems in the Internal Revenue Service's operations and financial management have placed an unacceptable burden on taxpayers and an equally unacceptable loss of revenue for the government. Even more alarming, most of these issues have plagued the IRS since 1992. Throughout the years, the IRS has acknowledged these issues and has pledged to take the necessary corrective actions. During this session, we will learn what progress has been made by the IRS in meeting this challenge. We will hear testimony from representatives of the General Accounting Office, the Internal Revenue Service, and the Department of the Treasury. I welcome each of the witnesses and look forward to their testimony.

[The prepared statements of Hon. Stephen Horn, Hon. Jim Turner, and Hon. Judy Biggert follow:]

ONE HUNDRED SIXTH CONGRESS

Congress of the United States

House of Representatives

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**"Results of the Internal Revenue Service's
Fiscal Year 1999 Financial Statements Audit"**
CHAIRMAN STEPHEN HORN (R-CA)
OPENING STATEMENT
February 29, 2000

A quorum being present, the Subcommittee on Government Management, Information, and Technology will come to order.

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Attempting to correct these problems, Congress passed several major legislative reforms, including the Chief Financial Officers Act of 1990, the Government Management Reform Act of 1994, and the Federal Financial Management Improvement Act of 1996. These laws were enacted to ensure that Federal agencies produce timely and accurate information which they need to manage their operations and measure the full cost and financial performance of their programs. Unfortunately, our previous subcommittee hearings have demonstrated that this important goal is a long way from being met.

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During this session, we will learn what progress has been made by the IRS in meeting this challenge. We will hear testimony from representatives of the General Accounting Office, the Internal Revenue Service, and the Department of the Treasury. I welcome each of our witnesses, and look forward to their testimony.

OPENING STATEMENT OF THE HONORABLE JIM TURNER
"AUDIT REPORT ON IRS'S FY 1999 FINANCIAL STATEMENTS"
GMIT SUBCOMMITTEE
FEBRUARY 29, 2000

Thank you, Mr. Chairman. As we approach the deadline for taxpayers to file their tax returns, it is appropriate to reflect on how well our tax collection system is working, a system that -- perhaps amazingly -- relies primarily on voluntary compliance with tax laws. Voluntary compliance cannot be effective if the American people lack confidence in the IRS, the agency responsible for processing federal taxes. Without taxes, our government could not provide the protection, benefits and services upon which we all rely and that we too often take for granted. Thus it is imperative to the well-being of this country that the IRS successfully fulfill its mission to collect the right amount of tax at the least cost to the taxpayers and to perform this service with the highest degree of public confidence in IRS's integrity, efficiency and fairness.

We are here today to examine the results of the audit of the Internal Revenue Service (IRS) for Fiscal Year 1999. Although this report focuses primarily on financial management, tax revenue collection and refund activities, and unpaid tax assessments, it also alerts readers to other significant issues facing the IRS, including filing fraud and information systems security weaknesses. The GAO has identified several significant material weaknesses in the IRS that need to be corrected, as well as identified some data that my not be reliable. In order for the IRS to perform its mission, it is imperative that the agency have accurate data. Failure to protect the integrity of the accounts could subject taxpayers to unnecessary burdens and result in a loss of revenue for the nation.

In this new era of federal agency management, agencies realize that they must not only provide top-quality government services, but also achieve it in a cost effective and efficient manner. Agencies must develop financial management systems capable of tracking their ongoing financial condition, assessing their financial vulnerabilities, and determining the most cost effective approach.

In its role as the nation's tax collector, the IRS has a demanding responsibility in collecting taxes, processing tax returns, and enforcing the nation's tax laws. The size and complexity of the IRS's operations present additional challenges to its management. I think we can all appreciate the monumental nature of the IRS's mission and its significance. Given the importance of its role, we must be vigilant not to let the implementation of the IRS's plans for correction fall through the cracks. I am pleased to learn that the IRS has made improvements in the past year. So, as we work together constructively to improve the IRS, I want to commend the agency on the progress it has made and am eager to discuss what improvements it will be making.

Statement of Representative Judy Biggert (R-IL)
Government Management Information and Technology Hearing
Oversight of financial management at the Internal Revenue Service
February 29, 2000

Good morning, Mr. Chairman.

I am pleased to participate in today's hearing regarding the financial management practices of the Internal Revenue Service (IRS). The financial well being of our federal departments and agencies must be a top oversight priority for this and every other Congress.

Chairman Horn has set an ambitious oversight agenda to ensure that our nation's federal agencies and departments have their fiscal house in order. I commend him for it.

For almost a decade, the General Accounting Office (GAO) has categorized the IRS as "high risk" for waste, fraud and abuse. Among other things, the GAO has found that the Agency suffers from long-standing weaknesses that prevent it from routinely generating timely and reliable information to be used to manage its operations or prepare financial statements.

It has found that IRS' controls over tax receipts and taxpayer data make information the Agency handles vulnerable to theft and inappropriate disclosure. And it has found that the IRS has been unable to collect billions in taxes due the government.

I am aware of and commend steps taken over this past decade by the IRS to address its management problems. In fact, the GAO reports that in fiscal year1997 the IRS for the first time since 1992 received an unqualified opinion on its financial statements.

Unfortunately, the GAO reported in January of 1999, as part of its Performance and Accountability Series, that the Agency's poor management controls "continue to expose the federal government to significant loss of tax revenue." Given the amount of money for which the IRS is responsible, this is a damning statement to be sure.

In response to problems of waste, fraud and abuse at the IRS and at other agencies, Congress has enacted several reform bills this past decade to ensure effective oversight of government programs. Among those that have been passed are the Chief Financial Officers Act of 1990, the Government Management Reform Act of 1995 and, in the case of the agency we are reviewing today, the IRS Restructuring and Reform Act of 1998.

Today's hearing presents this Subcommittee with an opportunity to review the impact of these laws on the IRS' financial management practices. We will find out of the IRS is a more accountable agency because of these reforms or whether these efforts were made in vain.

We will also examine the impact these reforms have had on the moral and productivity of IRS employees. Finally, we will review the need for further congressional action to ensure that the IRS does not continue put taxpayer dollars at risk

I trust that our expert panel of witnesses will help us work our way through the questions I have just posed. Their expertise in the field of government management will be useful as we explore ways to rid our government of waste, fraud and abuse. I am also looking forward to hearing their thoughts on where the IRS is headed as an agency.

Again, Mr. Chairman, I thank you for calling this important oversight hearing. I have enjoyed working with you in the past on financial management practices and believe our work today will be of benefit to both taxpayers and the government.

Thank you.

Mr. HORN. We will now swear in the witnesses and they are—let me just go—note who is here.

Mr. Gregory Kutz, the Associate Director of Government-wide Accounting and Financial Management, Accounting and Information Management Division, U.S. General Accounting Office, part of the legislative branch. He is accompanied by Steven J. Sebastian, the Assistant Director.

Next will be Mr. Lawrence W. Rogers, Acting Chief Financial Officer of the Internal Revenue Service, accompanied by John M. Dalrymple, Chief Operations Officer; and Mr. Steven App, the Deputy Chief Financial Officer of the Department of the Treasury.

So, gentlemen, if you will rise and raise your right hands.

[Witnesses sworn.]

Mr. HORN. The clerk will note that all five witnesses affirmed the oath.

We will start with Mr. Kutz, who is Associate Director, Governmentwide Accounting and Financial Management. So please begin.

STATEMENT OF GREGORY D. KUTZ, ASSOCIATE DIRECTOR, GOVERNMENT-WIDE ACCOUNTING AND FINANCIAL MANAGEMENT, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY STEVEN J. SEBASTIAN, ASSISTANT DIRECTOR

Mr. KUTZ. Mr. Chairman, good morning. It is a pleasure to be here to testify on the results of our audit of IRS's fiscal year 1999 financial statements. The financial activities in these statements are enormous when compared to other entities, including $1.9 trillion in tax revenue, $185 billion in refunds, and $21 billion in net taxes receivable. With me this morning is Steve Sebastian who works with me on the financial audit of IRS. I also thank IRS senior management and staff across the country for their cooperation and professionalism throughout this year's audit.

The bottom line of my testimony this morning is that IRS does not have reliable financial and performance information that is needed to effectively manage its operations. In addition, control deficiencies relating to unpaid taxes and refunds have likely cost the Federal Government billions of dollars.

My testimony this morning is in three parts. First, the results of our 1999 audit; second, problems IRS has in accounting for and managing its $8 billion appropriation; and third, weaknesses in controls and management of unpaid taxes and refunds.

Before providing the results of our fiscal year 1999 audit, I want to recognize the IRS for its notable progress this year in seven areas: financial reporting, accounts payable, suspense accounts, documentation of unpaid taxes, fund balance with Treasury reconciliations, computer security, and controls over hard-copy taxpayer data. We commend the IRS for their progress in these seven areas. We also commend the IRS for issuing their financial statements by the March 1st statutory deadline for the third consecutive year.

The audit results for fiscal year 1999 include opinions on IRS's six financial statements and an opinion on internal controls and a report on compliance with laws and regulations. Our opinion on IRS's statement of custodial activities is unqualified. This means that the $1.9 trillion in tax revenue and $185 billion in refunds are reliable. Our opinion on IRS's balance sheet is qualified; except for issues relating to net position, IRS's balance sheet is reliable.

Our opinions on the other four financial statements, the statements of net cost, changes in net position, budgetary resources, and financing, are disclaimers. Because of problems relating to IRS's systems and controls, we were unable to determine whether the information in these financial statements is reliable.

Our opinion on IRS's internal controls is that they are not effective. In addition, we found noncompliance relating to the structuring of taxpayer installment agreements and the releasing of Federal tax liens. We also concluded that IRS's systems do not comply with the Federal Financial Management Improvement Act. Because of a number of problems, we were unable to determine whether IRS complied with the Antideficiency Act.

I want to stress that although an unqualified audit opinion is a recognized accomplishment that IRS should strive for, it is not the ultimate goal. Rather, the ultimate goal is for IRS to routinely produce reliable financial and performance information to use in managing its operations.

Let me move on to a discussion of my second point, which relates to problems IRS has in managing an accounting for activity related to its $8 billion budget. My discussion will focus on undelivered orders and property and equipment.

The qualification of IRS's balance sheet related to problems we found primarily with the undelivered orders component of net position. Undelivered orders represent the cost of goods and services that have been ordered, but have not been received. In testing a sample of year-end undelivered orders, we found a 42 percent error rate.

For example, a large number of items recorded as undelivered had, in fact, been delivered before year-end. In addition, many of the items in our sample were no longer valid orders. Undelivered orders is a key budgetary account. IRS needs reliable budgetary information to effectively manage its operations.

In our 1998 audit, we reported that IRS's property and equipment was likely materially understated. Because IRS could not rely on its own records, it hired consultants and appraisers to develop a projected year-end balance. This effort increases IRS's property and equipment balance by over $1 billion or 600 percent. Although IRS was able to develop a reliable estimate at September 30, 1999, the chronic problems in the underlying property and equipment inventory remain. For example, when verifying the items in IRS's inventory, we found at one location that 200 personal computers in IRS's records had actually been disposed of. We also found videoconferencing equipment and three new mail sorting machines costing over $800,000 each that were not in IRS's records.

Finally, we found numerous errors in IRS's records relating to costs. For example, a Compaq laptop computer was incorrectly recorded at a cost of $310,000, and a copy of Microsoft office software costing $213 was erroneously recorded at $212,300. IRS itself has reported property and equipment as a material weakness since 1983.

My third and most important point is that IRS continues to have difficulty managing unpaid taxes and refunds. The difficulty has resulted in burden to taxpayers and has likely cost the Federal Government billions of dollars. The problems we found are a result of human error, systems limitations, and according to the IRS, resource constraints.

For fiscal year 1999, we found that taxpayer records contained errors that IRS had not caught and resolved in a timely manner. For example, we found delays in posting trust fund recovery penalty payments to all appropriate taxpayer accounts. Some payments made by taxpayers as far back as the late 1980's were still not properly recorded.

We also found delays in correcting erroneous assessments due to data input errors. In one case, IRS took 18 months to correct an erroneous assessment of over $160,000 against a taxpayer that was actually owed a refund. The case file indicated that IRS knew of the error 10 months before it was finally corrected.

Last August, Mr. Sebastian and I testified before this subcommittee that outdated systems and ineffective processes make it difficult for IRS to effectively collect delinquent taxes. At that hearing, the Commissioner noted that IRS's systems are fundamentally deficient in this area.

In addition to these problems, we found, during our 1999 audit, numerous unpaid taxes with collection potential that are not being pursued by the IRS. During fiscal year 1999, in order to reduce a backlog of unassigned cases, IRS removed $2.4 billion of cases from its field collection inventory. As a result, these cases were closed without filing a tax lien or taking normal collection action. Some of these cases that we reviewed appeared to have some collection potential.

In addition, we found other unassigned cases that had collection potential. For example, in one case, we noted a doctor that owed taxes of over $100,000 from as far back as the late 1980's. Although this individual had 1998 adjusted gross income of nearly $200,000, the case was not being actively pursued.

As we have reported in prior years, IRS has ineffective controls that allow invalid refunds to be disbursed. According to IRS, it relies primarily on detective controls in this area. In fiscal year 1999, we found significant gaps in the effectiveness of these detective controls. For example, months after the filing season, IRS matched its tax return information to third-party income information such as W–2s and 1099s. This matching procedure is intended to identify under-reported income.

For tax year 1996, IRS screened about 155 million individual income tax returns and found that 12 million had potential taxes due of $15 billion. However, IRS investigated only 25 percent of these returns relating to about $5 billion. Thus, IRS did not pursue nearly 9 million taxpayers with $10 billion of potential unpaid taxes.

Historically, the earned income tax credit has been vulnerable to high rates of invalid claims. In fiscal year 1999, $26 billion of the $30 billion of EITC claims were refunded. During fiscal year 1999, IRS examined 573,000 suspicious returns claiming $1.25 billion in EITC and found that 86 percent of the claims were invalid. If these examinations are done before the refund is disbursed, that is an effective preventive control. However, according to IRS, 30 percent of these examinations were completed after the refund was disbursed.

In summary, IRS cannot do some of the basic accounting and recordkeeping tasks that it expects of American taxpayers. IRS must resolve the financial and operational issues discussed in our report to provide quality customer service and fulfill its responsibility as the Nation's tax collector. Gaps in the effectiveness of controls over unpaid taxes and refunds have likely cost the Federal Government billions of dollars. We believe that the vast majority of American taxpayers comply with the Tax Code. However, failure to pursue and collect taxes due could substantially reduce future compliance and erode compliant taxpayers' confidence in the current system.

During fiscal year 1999, IRS senior management demonstrated a high level of involvement and commitment to addressing many of the issues discussed in our report. We encourage IRS to sustain the progress made in 1999 and use it as a building block for further improvement in the future. In addition, the success of IRS's long-term modernization efforts is critical to resolving the challenges we are talking about today. We are committed to working with IRS in fiscal year 2000 and future years to develop lasting solutions to these issues.

Mr. Chairman, this concludes my testimony. Mr. Sebastian and I will be happy to respond to any questions.

[The prepared statement of Mr. Kutz follows:]

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Government Management, Information and Technology, Committee on Government Reform, House of Representatives

For Release on Delivery
Expected at
10 a.m.
Tuesday,
February 29, 2000

INTERNAL REVENUE SERVICE

Results of Fiscal Year 1999 Financial Statement Audit

Statement of Gregory D. Kutz
Associate Director, Governmentwide Accounting and Financial Management Issues
Accounting and Information Management Division

GAO
Accountability * Integrity * Reliability

GAO/T-AIMD-00-104

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the results of our audit of the Internal Revenue Service's (IRS) fiscal year 1999 financial statements, for which we are issuing our report today.[1] This audit is important because it provides an independent report to IRS senior management, the Congress, and the nation's taxpayers on IRS' progress in improving its financial and operations management. IRS' financial statements are important to the federal government because they report on its stewardship of $1.9 trillion in federal tax revenues collected, $185 billion in tax refunds disbursed, and $21 billion in net taxes receivable owed to the government. They also report on IRS' activities associated with its fiscal year 1999 appropriations of over $8 billion.

IRS has a demanding responsibility in collecting taxes, processing tax returns, and enforcing the tax laws in its role as the nation's tax collector. The size and complexity of IRS' operations present additional challenges to its management. IRS is a large, complex, decentralized organization with about 100,000 people in 4 regional offices, 33 district offices, 10 service centers, 3 computing centers, and numerous other field offices that it operates throughout the United States.

About 1 year ago, we appeared before this Subcommittee to discuss the results of our audit of IRS' fiscal year 1998 financial statements.[2] At that hearing, we noted that serious internal control and financial management issues continued to plague the agency. While IRS has made progress in addressing some of these issues, the results of our fiscal year 1999 financial audit revealed that the agency continues to experience pervasive material weaknesses in the design and operation of its automated financial management and related operational systems, accounting procedures, documentation, recordkeeping, and internal controls, including computer security controls. As they relate to IRS' administrative activities, these weaknesses prevented us from rendering an unqualified opinion on five of IRS' six financial statements, although IRS made significant progress in reporting more reliable information on its balance sheet. IRS was able to reliably report on the results of its custodial activities for fiscal year 1999, including tax revenue received, refunds disbursed, and taxes receivable due from the public. However, this achievement, as well as other improvements in the reliability of certain amounts reported on its balance

[1]See *Financial Audit: IRS' Fiscal Year 1999 Financial Statements* (GAO/AIMD-00-76, February 29, 2000).

[2]See *Internal Revenue Service: Results of Fiscal Year 1998 Financial Statement Audit* (GAO/T-AIMD-99-103, March 1, 1999).

sheet, comes at a high cost in that it takes extensive, costly, and time-consuming efforts to overcome pervasive internal control and systems weaknesses.

The major issues identified in our fiscal year 1999 audit include the following:

- deficiencies in controls to properly manage unpaid assessments, resulting in both taxpayer burden and potentially billions of dollars in lost revenue to the government;
- deficiencies in controls over tax refunds, permitting the disbursement of potentially billions of dollars of improper refunds;
- vulnerabilities in controls over hardcopy tax receipts and taxpayer data that increase the government's and taxpayers' risk of loss or inappropriate disclosure of taxpayer data;
- vulnerabilities in computer security that may allow unauthorized individuals to access, alter, or abuse proprietary IRS programs and electronic data and taxpayer information;
- the failure to reconcile IRS' fund balance with Treasury records throughout fiscal year 1999, resulting in IRS' inability to routinely ensure accountability and proper use of its funds;
- inadequate systems and controls that resulted in the inability to properly account for IRS' property and equipment and related costs;
- inadequate budgetary controls, resulting in IRS' inability to assure that its budgetary resources are being properly accounted for, reported, and controlled; and
- an inadequate financial reporting process that continued to result in (1) IRS' inability to reliably prepare several of the required financial statements and (2) financial management systems that do not comply with the requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996.

Many of these issues have plagued IRS since we began auditing the agency's financial statements for fiscal year 1992,[3] first under the authority of the Chief Financial Officers Act of 1990 and later under the authority of

[3] *Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements* (GAO/AIMD-93-2, June 30, 1993).

the Government Management Reform Act of 1994. Beginning with our first audit, we have issued reports containing numerous recommendations to assist IRS in correcting these deficiencies. IRS has had some success in addressing some of these deficiencies. Specifically, in fiscal year 1999, we noted improvements in IRS' (1) overall financial reporting, (2) records of accounts payable, (3) amounts held in suspense, (4) documentation of unpaid tax assessments, (5) reconciliation of fund balance with Treasury, (6) computer security, and (7) handling of hardcopy taxpayer receipts and data, including courier security. Additionally, for the past 3 years, IRS has been able to compensate for some of its internal control and systems deficiencies through ad hoc computer programming and substantial manual intervention to derive reliable year-end information on its tax revenue and refund activities.

During fiscal year 1999, IRS focused substantial efforts on developing compensating processes to work around its serious systems and control weaknesses in order to derive year-end balances for its financial statements. These processes and efforts enabled IRS to improve the reliability of its reported year-end information. However, this approach relies heavily on costly, time-consuming processes, statistical projections, external consultants, and monumental human efforts to derive year-end balances due to the lack of reliable financial management and operational systems. More important, this approach does not produce the timely and reliable financial and performance information IRS needs for decision-making on an ongoing basis, nor does it address the underlying financial management and operational issues that adversely affect IRS' ability to effectively fulfill its responsibilities as the nation's tax collector. The challenge for IRS will be to build on the improvements made in fiscal year 1999 in future years to not only improve its compensating processes but also to develop and implement the fundamental long-term solutions that are needed to address the management challenges we have identified.

Many of the problems facing IRS represent serious agencywide financial management and operational challenges that will require a substantial and continuous commitment of resources, time, and expertise to correct. IRS has major efforts under way to modernize both its organizational structure and its information systems. These efforts appear to be heading the agency in the right direction, but, as IRS itself has stated, successful modernization of its information systems will take years to fully achieve.

While many of IRS' problems require long-term solutions, others, while serious, can be effectively addressed in the near term through concerted effort on the part of IRS management. During fiscal year 1999, IRS senior management demonstrated a high level of involvement and commitment to overcome some of the operational and financial management issues identified by our audits, and this involvement contributed significantly to the actions taken during the year to address some of these issues. Continued involvement and commitment at this level will be essential to IRS' ability to successfully address the serious problems that remain.

I would now like to summarize the major issues identified in our fiscal year 1999 audit.

Management of Unpaid Tax Assessments

During fiscal year 1999, we found that serious internal control issues continued to affect IRS' management of unpaid assessments. The lack of an effective subsidiary ledger; errors and delays in recording assessments, payments, and other activities; lack of adherence to procedures; and the failure to actively pursue significant amounts in outstanding taxes owed to the federal government hinder IRS' ability to effectively manage unpaid assessments and maximize collections while avoiding undue taxpayer burden.

IRS continues to lack a subsidiary ledger that tracks and accumulates unpaid assessments and their status[4] on an ongoing basis. Because it lacks such a subsidiary ledger, IRS is unable to promptly identify and focus collection efforts on accounts most likely to prove collectible and is impeded in its ability to prevent or detect and correct errors in taxpayers' accounts. Additionally, IRS records continued to contain errors and IRS continues to experience significant delays in recording activity in taxpayer accounts. Also, during fiscal year 1999, IRS continued to enter into installment agreements with taxpayers for less than the full amount of taxes owed, and IRS did not always promptly release liens filed against the property of taxpayers who subsequently paid off or otherwise satisfied their outstanding tax liabilities. These conditions resulted in instances of unnecessary taxpayer burden and lost opportunities to collect outstanding taxes owed. We found the following.

- Significant delays—in some instances in excess of 10 years—in recording payments made by taxpayers to related taxpayer accounts. We also found

[4]Unpaid assessments consist of (1) taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling (federal taxes receivable), (2) compliance assessments where neither the taxpayer nor the court has affirmed that the amounts are owed, and (3) write-offs, which represent unpaid assessments for which IRS does not expect further collections due to factors such as taxpayers' death, bankruptcy, or insolvency. Of these three classifications of unpaid assessments, only federal taxes receivable are reported on the principal financial statements. As of September 30, 1999, IRS reported $21 billion (net of an allowance for doubtful accounts of $56 billion), $27 billion, and $127 billion in these three categories, respectively. See appendix I for components of IRS' balance of unpaid assessments at September 30, 1999, and appendix II for a comparison of IRS taxes receivable between fiscal years 1998 and 1999.

payments that were not recorded at all in related taxpayer accounts. Some of these delayed or unrecorded payments were made in the late 1980s.

- Delays in making or recording assessments against taxpayers. In some instances, these delays resulted in lost opportunities for IRS to offset refunds owed to taxpayers for subsequent tax periods against their outstanding tax liabilities. In one case, an individual received a $15,000 refund at the same time that IRS identified this individual as owing nearly $350,000 in outstanding taxes. However, the tax assessment was not recorded in IRS' systems until nearly 9 months later.

- Delays in correcting erroneous assessments resulting from data input errors. In one case, it took 18 months for IRS to correct an input error that resulted in an erroneous assessment of over $160,000 against a taxpayer who was actually due a refund. The case file indicated that IRS personnel believed the assessment was erroneous 10 months before correcting the account.

- Installment agreements whose payment terms will not result in full payment of the outstanding taxes and that are thus not in compliance with the Internal Revenue Code. In one case, the taxpayer entered into an installment agreement covering five separate tax periods with a total outstanding balance of $115,000. However, only $43,000 (37 percent) would be collected before the expiration of the statutory collection period[5] for these tax liabilities, assuming the taxpayer continues to make the payments through the statutory collection periods.

- Delays in releasing tax liens against properties owned by taxpayers who paid off or otherwise satisfied their tax liabilities. Specifically, in 26 percent of the cases we tested, IRS did not release the applicable federal tax lien within the 30-day requirement stipulated in the Internal Revenue Code. In one case, we found that the taxpayer had paid off his three outstanding tax liabilities by October 1998; however, as of December 1999—14 months later—IRS had not initiated action to release the lien against the taxpayer's property.

The first two conditions discussed above most frequently surfaced in cases involving unpaid payroll taxes, where separate accounts are established

[5]The statutory collection period for collecting taxes is generally 10 years from the date of the tax assessment. However, this period can be extended under a variety of circumstances, such as agreements by taxpayers to extend the collection period, bankruptcy litigation, and court appeals. Consequently, some tax assessments can and do remain on IRS' records for decades.

and assessments recorded for a related tax liability.[6] IRS' current systems cannot automatically link each of the multiple assessments made for the one tax liability. Consequently, if the business or one of its officers pays some or all of the outstanding taxes, IRS' systems are unable to automatically reflect the payment as a reduction in the related account or accounts. In 45 percent of the unpaid payroll tax cases we reviewed involving multiple assessments, we found that payments were not accurately recorded to reflect each responsible party's reduction in tax liability. IRS' efforts to address this serious system deficiency have thus far had limited success in reducing the extent of inaccuracies in taxpayer accounts.

We also identified many instances in which accounts that appeared to have some collection potential were not being actively pursued by IRS. This was in part due to IRS' changing its criteria for determining which accounts would be actively worked in response to an increasing inventory workload and its judgment that resource constraints would not permit the agency to actively pursue the cases. There is a point at which it ceases to be cost effective to pursue collection. However, for numerous cases, available information indicated that the taxpayers had financial resources available to pay at least some of the amounts owed; yet these cases were not being actively pursued. Additionally, in one case, IRS had seized property owned by a taxpayer who owed over $4 million in outstanding taxes and was in the process of auctioning it off to collect on at least a portion of these taxes, yet, with no reasonable explanation, IRS pulled the property from auction and later returned it to the taxpayer. IRS' failure to pursue certain taxpayers owing taxes to the federal government could result in billions of dollars in outstanding amounts going uncollected and adversely affect future compliance.

Controls Over Refunds

IRS does not have adequate controls to sufficiently reduce the risk that inappropriate tax refunds are made. Specifically, IRS does not have adequate (1) preventive controls to stop disbursements of invalid refunds or (2) detective (post refund) controls to identify invalid refunds that have been disbursed so that collection efforts may be pursued. IRS does not (1) compare the information on tax returns to third-party data such as W-

[6] When a company does not pay the taxes that have been withheld from employees' wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess the responsible officers individually for the taxes withheld from employees. IRS may record the assessments against each of several individuals for the employee withholding component of the payroll tax liability of a given business in an effort to collect the total tax liability of the business. While the assessments made against business officers—known as trust fund recovery penalties—are a necessary enforcement tool, IRS should collect the unpaid tax only once.

2s (Wage and Tax Statements) in time to identify and correct discrepancies between these documents before issuing refunds, (2) always review Earned Income Tax Credit (EITC) claims in time to identify invalid claims before they result in refunds, (3) always post assessments to taxpayer accounts promptly, and (4) have adequate controls to prevent duplicate refunds from being issued. These conditions expose the government to potentially significant losses due to inappropriate refunds. IRS' investigators identified nearly $16 million in potentially fraudulent refunds that had been disbursed during the first 9 months of calendar year 1999 and prevented the disbursement of an additional $498 million in potentially fraudulent refund claims. The full magnitude of invalid refunds disbursed by IRS is unknown, but could be in the billions of dollars.

IRS does not compare tax returns to W-2s and 1099s at the time tax returns are processed because it believes this (1) is not practical due to the intensive labor involved in performing such comparisons and (2) would adversely affect IRS' ability to promptly process tax returns and issue refunds. However, IRS has never provided us with a cost-benefit analysis to support its contentions, as we previously recommended. Additionally, our work on unpaid assessments has shown that once an inappropriate refund has been made, there is little likelihood that IRS will be able to recover it.

Instead of this up-front comparison, IRS relies on automated programs that are run months later, with subsequent follow-up on some identified differences serving as a compensating detective control. However, in addition to IRS' running these programs too late to prevent issuance of erroneous or fraudulent refunds, we found that IRS is not effectively applying this detective control to millions of tax returns estimated to have billions of dollars of underreported tax liabilities. For example, for tax year 1996,[7] IRS' matching program for individual taxpayers screened about 155 million individual income tax returns and found that about 12 million (8 percent) had potential underreported taxes due totaling at least $15 billion. However, IRS investigated only about 3.1 million (26 percent) of these tax returns, accounting for estimated underreported taxes due of about $5.2 billion (35 percent). In addition, IRS did not investigate any of the more than 688,000 discrepancies found by its matching program for employment tax returns filed during fiscal year 1996. According to IRS, resource constraints kept it from investigating more of these discrepancies. The full magnitude of the potential unpaid taxes related to the discrepancies not investigated by IRS is unknown. Additionally, to the

[7]Tax year 1996 is the most recent year for which substantially complete matching program results are available.

extent that IRS does not actively pursue collection of the cases identified in its matching program for which it assesses additional taxes, the effectiveness of this process is further diminished.

Historically, EITCs have been vulnerable to high rates of invalid claims.[8] Since most EITCs result in refunds,[9] the risk of invalid refunds being disbursed is significantly increased. In an effort to minimize this risk, IRS relies on past experience to screen tax returns claiming EITCs to identify (for detailed examination) EITC claims considered most likely to be invalid. During fiscal year 1999, IRS examiners using this screening process examined about 573,000 tax returns claiming $1.25 billion in EITCs and found that $1.08 billion (86 percent) were invalid. These examinations are an important control mechanism for detecting questionable claims and deterring future invalid claims, but they do not prevent the disbursement of inappropriate refunds relating to EITCs. The magnitude of refunds resulting from invalid EITCs is unknown. In fiscal year 1998, IRS began implementing a 5-year EITC compliance initiative intended to address noncompliance problems with EITCs. IRS is in the process of evaluating the effectiveness of its initiative. However, the high rate of invalid EITC claims found during IRS examinations suggests that invalid EITC claims continue to be significant.

Manual Tax Receipts and Taxpayer Information

IRS continues to have weaknesses in controls designed to safeguard cash, checks, and related hardcopy taxpayer data it manually receives from taxpayers. These weaknesses expose taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to confidential information entrusted to IRS.

Specifically, in fiscal year 1999, we continued to find that IRS employed individuals to process cash, checks, and other taxpayer data before receiving satisfactory results of fingerprint checks. At the seven IRS service centers that reported data, 4,835 employees that were hired to process taxpayer receipts or data for the 1999 filing season entered on duty before their fingerprint checks were completed. Fingerprint check results for 138 (3 percent) of these employees later disclosed unsuitable backgrounds. Of the 138 employees, the backgrounds of 65 (47 percent) were considered severe enough to result in their termination or forced resignation from IRS. We also identified other weaknesses, including

[8] See *High-Risk Series: An Update* (GAO/HR-99-1, January 1999); *Major Management Challenges and Program Risks: Department of the Treasury* (GAO/OCG-99-14, January 1999); and *Financial Audit: IRS' Fiscal Year 1998 Financial Statements* (GAO/AIMD 99-75, March 1, 1999).

[9] During fiscal year 1999, IRS processed about $30 billion in EITCs. Of this amount, about $26 billion (87 percent) was refunded, and the rest reduced tax assessments.

returned refund checks that were not immediately voided or locked up as required by IRS policy, and service center guards and staff who did not ask a courier for identification before he entered the service center or before they handed him a $28 million deposit, even though he was not the regular courier. We found that similar weaknesses existed at commercial lockbox banks IRS contracts with to process tax receipts, including the hiring of temporary employees to handle taxpayer receipts and other data before receiving satisfactory fingerprint results.

These weaknesses increased IRS' vulnerability to theft or loss. For example, in fiscal year 1999, IRS identified 37 actual or alleged employee thefts of receipts at IRS field offices and lockbox banks, totaling over $1 million. An additional eight cases were opened during the period in which the amount potentially stolen was not quantified because the investigations were still ongoing and the thefts had not yet been verified, or the stolen checks were never negotiated. Our work in prior years has shown that employee thefts have also occurred in the past and have resulted in taxpayer burden.[10] Furthermore, the number of thefts not identified by IRS is unknown.

IRS has taken action to address some of the control deficiencies related to tax receipts and taxpayer data that we reported in prior years. For example, IRS eliminated the use of bicycle or foot couriers to transport deposits to financial institutions and issued enhanced courier security procedures after year-end. Also, unauthorized personnel, such as security guards, are now prohibited from accepting tax payments at service centers.

Nonetheless, it is important that corrective action be taken to address the remaining vulnerabilities because these issues are critical to IRS' successfully meeting its customer service goals.

Computer Security

IRS relies extensively on computer information systems to perform basic functions such as processing tax returns and payments, maintaining sensitive taxpayer data, calculating interest and penalties, and generating refunds. Consequently, weaknesses in controls over its computer information systems could impair IRS' ability to perform these vital functions and increase the risk of the unauthorized disclosure, modification, or destruction of taxpayer data.

[10] See *Internal Revenue Service: Physical Security Over Taxpayer Receipts and Data Needs Improvement* (GAO/AIMD-99-15, November 30, 1998).

IRS substantially improved computer security at its facilities and corrected a significant number of the computer security weaknesses identified in our previous audits. In addition, IRS has established and is implementing a servicewide computer security planning and management program that, when fully implemented, should help IRS effectively manage its computer security risks. As part of its effort to implement this program, IRS is updating its access control standards to reflect changes in technology and operating environments, providing computer security training to personnel, and conducting computer security self-assessment reviews that identify and mitigate vulnerabilities on a proactive basis.

At the same time, much remains to be done to resolve the significant control weaknesses that exist within IRS' computing environment. During fiscal year 1999, we continued to find serious weaknesses with IRS' general controls designed to protect computing resources such as networks, computer equipment, software programs, data, and facilities from unauthorized use, modification, loss, and disclosure. Such computing resources also include systems operated and maintained by other government entities such as Treasury's Financial Management Service. IRS did not always (1) effectively implement controls to prevent, limit, or detect access to computing resources, (2) adequately segregate system administration and security administration responsibilities, (3) optimally configure system software to ensure the security and integrity of system programs, files, and data, (4) sufficiently plan or test the activities required to restore critical business systems when unexpected events occur, and (5) routinely monitor key networks and systems to identify unauthorized activities and inappropriate system configurations. In addition, internal controls over IRS' key computer applications that manage budget execution, tax return input, and receipt processing do not provide adequate assurance that only authorized personnel have access to the applications and related data, that the data are complete and accurate, and that application and data integrity is maintained.

These weaknesses increase the risk that data processed by IRS' computer systems are not reliable. If IRS does not adequately mitigate these weaknesses, unauthorized individuals could gain access to critical hardware and software where they may intentionally or inadvertently add, alter, or delete sensitive data or computer programs. These individuals could also obtain personal taxpayer information and use it to commit financial crimes using taxpayers' names (identity fraud), such as fraudulently establishing credit and running up debts.

Fund Balance With Treasury

Despite substantial efforts, IRS was unable to reconcile its administrative fund balance with Treasury accounts[11] throughout fiscal year 1999. Such reconciliations are required by Treasury policy and are analogous to companies or individuals reconciling their checkbooks to monthly bank statements.

Unlike during fiscal year 1998, when IRS did not attempt to reconcile its fund balance, IRS made a concerted effort to reconcile its fund balance with Treasury accounts during fiscal year 1999. IRS devoted significant time and staff resources to try to correct its records for the effects of these adjustments. However, its efforts were hindered due to its inability to correct its records for unsupported adjustments of approximately $84 million and $60 million recorded to its general ledger in fiscal years 1997 and 1998, respectively, to force its records to match Treasury's records.[12] These adjustments represented an accumulation of unidentifiable differences between Treasury's and IRS' records. IRS had posted these adjustments for several years without first performing the necessary research to determine whether adjustments to the general ledger were, in fact, needed or whether some or all of these differences were attributable to errors in Treasury's records. This is similar to an individual not reconciling his or her checkbook with monthly bank statements for years, and then adjusting the checkbook to agree with the balance per the latest bank statement without first verifying that the bank had not made any mistakes. Because some of the adjustments IRS had made related to differences going back as far as fiscal year 1995, IRS' ability to research and make proper correcting entries was further hindered.

In late January 2000, after several unsuccessful attempts, IRS was able to provide us with a reconciliation of its 1999 fiscal year-end fund balance with Treasury that was sufficiently complete to enable us to conclude that the amount reported in its financial statements for fund balance with Treasury as of September 30, 1999, was reliable. However, reconciling differences between IRS and Treasury records related to payroll continue to exist. These differences need to be fully researched to determine the extent to which IRS' fund balance may be misstated and in need of further adjustments. These unresolved differences and IRS' lack of routine and

[11] Like other agencies, IRS records administrative budget spending authorizations in the asset account titled "fund balance with Treasury." The funds maintained in this account are used to fund IRS' operations. IRS' fund balance with Treasury account is composed of 43 appropriation accounts that IRS increases or decreases as it receives or disburses funds.

[12] The problems related to adjusting agency records to match the amounts reported by Treasury have been noted in other GAO reports. See *Financial Audit: Issues Regarding Reconciliations of Fund Balance With Treasury Accounts* (GAO/AIMD-99-271, September 1999).

complete reconciliations during fiscal year 1999 raise serious concerns about its ongoing ability to ensure that it complies with the law governing the use of its budget authority. Without this crucial control, it is difficult, if not impossible, for IRS to determine if operating funds are being properly spent or if reported amounts for program costs, assets, and liabilities are reliable.

Property and Equipment

IRS has seriously flawed systems and controls over its property and equipment (P&E). As a result, IRS is unable to rely on its P&E subsidiary records to account for or report its inventory of P&E assets in accordance with federal accounting standards.[13] IRS does not have an integrated property management system that appropriately records P&E additions and disposals as they occur. Instead, IRS expenses property purchases during the year, then records adjustments at year-end to reflect P&E dispositions and to move property purchases from expenses to P&E based on subsidiary records maintained at field offices. However, these subsidiary records are unreliable because IRS' procedures to ensure that P&E purchases and disposals are properly recorded in these records are not consistently followed. In addition, as a result of these inaccurate records, IRS' Chief Information Officer found it necessary to conduct a comprehensive and costly inventory of computer equipment and software to ensure that all of IRS' critical systems were identified and made Year 2000 compliant. IRS itself has reported deficiencies in its property management controls for the last 18 consecutive years, yet serious issues continue to go uncorrected.

During fiscal year 1999, we continued to find significant errors in the quantities and valuations of P&E included in IRS' P&E subsidiary records. These errors are the result of ineffective IRS procedures to capture additions and disposals of P&E. Specifically, IRS relies on individuals across the country to inform those responsible for maintaining the subsidiary records of any P&E additions or disposals. At one IRS location we visited, the procedure for updating the P&E records for property purchases consisted of the individual receiving the property making a long-distance telephone call to another individual responsible for recording the acquisition in the subsidiary records. We found that procedures for recording P&E frequently were not followed, resulting in numerous errors. For example, we found that 25 percent of the 106 P&E items we inventoried at IRS field offices were not included in the P&E records, including videoconferencing equipment and three recently

[13] Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property, Plant, and Equipment.*

acquired mail-sorting machines that cost over $800,000 each. We also noted that 200 personal computers that had been disposed of were still included in IRS' records. In addition, we found that P&E was consistently recorded based on internal documents such as purchase orders or requisitions that may not reflect the actual invoice price paid, and that, contrary to federal accounting standards, shipping and installation costs were excluded from the recorded value. We found other valuation errors in IRS' records, such as a Compaq laptop computer recorded at a cost of $310,000 and a copy of Microsoft Office software that cost $212 but was erroneously recorded at $212,300.

The quality of its P&E records was so poor that IRS determined it could not rely on the records to report the balance on its financial statements. Consequently, IRS hired a consulting firm to develop a balance based primarily on a statistical estimate. The resulting estimate of $1.3 billion of net P&E at September 30, 1999, in turn resulted in an upward adjustment of over $1 billion (600 percent) to IRS' accounting records. This substantial adjustment confirmed our fiscal year 1998 conclusion that IRS' P&E balance was likely materially understated. In addition to the problems previously discussed, this substantial adjustment was necessary because IRS excluded over $250 million of external software and systems development costs and $65 million of assets under capital lease. The material adjustment to IRS' P&E balance was also necessary because IRS' prior practice of using Treasury's capitalization threshold of $50,000 was inappropriate. The use of this threshold in the past resulted in hundreds of millions of dollars in P&E purchases being expensed in the year of purchase instead of being properly reported as assets. While IRS' costly and time-consuming effort did produce a reasonable P&E balance at year-end, its inability to distinguish P&E asset purchases from expenses or to reliably report depreciation expense continued to contribute to its inability to produce reliable statements of net cost, changes in net position, and financing.

Before IRS undertook its costly year-end estimate of P&E, we recommended that its management ensure that systems and controls be in place for fiscal year 2000 to properly record additions and disposals of P&E. If IRS does not implement needed improvements for fiscal year 2000, it will have spent over $1 million on an estimate that was reliable for only 1 day, and it may be unable to properly account for the billions of dollars it plans to spend on tax systems modernization over the next decade.

Budgetary Controls

IRS' internal controls are not adequate to provide reasonable assurance that the budgetary balances reported on its financial statements are reliable or that its obligations do not exceed budgetary resources. This contributed to our inability to determine whether four of IRS' six financial statements were reliable at September 30, 1999, as well as whether the components of net position were reliable. IRS does not have current, accurate budgetary information and reliable budgetary controls to successfully manage operations on an ongoing basis and to ensure that resources are expended only in accordance with established budget authority.

We found errors in 42 percent of a statistical sample of 130 undelivered orders[14] at September 30, 1999, including the following.

- Undelivered orders dating back as far as 1996 that IRS should have deobligated. For example, we found $2.8 million for an undelivered order relating to computer services for which the last invoice was received in fiscal year 1996, but the remaining unneeded amount had not been deobligated.
- Goods or services that had been received but the amount was not removed from IRS' undelivered orders. For example, we found fiscal year 1999 telephone services for approximately $2 million that were not recorded as expenses and reductions of undelivered orders, and $2.2 million of computer services that had been received before September 30, 1999, but were still shown as an undelivered order. These overstatements of undelivered orders resulted in understatements of IRS' accounts payable.

Additionally, we found that IRS' automated controls over the use of its budgetary resources were not effective. Specifically, IRS allowed excessive numbers of individuals to have the capability to override its automated spending controls. We found that 76 percent of the 1,749 users that had access to IRS' budgetary control system had some capabilities to override controls that could allow expenditures to exceed amounts obligated. Of these users, 87 also had the ability to override appropriation-level spending controls that could allow expenditures to exceed amounts appropriated.

IRS also did not promptly record all expenditures in the accounts of the appropriations authorized to pay them. Instead, for some expenditures for which the funding information and/or supporting documentation was incomplete, IRS recorded the transactions in suspense accounts while awaiting supporting documentation. IRS made substantial improvements

[14]Undelivered orders represent the value of goods and services that have been ordered and obligated but have not been received.

in its handling of suspense items and was able to reduce the amount held in suspense from more than $140 million at September 30, 1998, to about $8 million at September 30, 1999. However, transactions continue to remain in suspense for months or, in some cases, years. For example, IRS still had a number of charges from the General Services Administration that were recorded in its suspense account in 1996. Until these suspense transactions are posted to the proper appropriation accounts and matched with corresponding obligation records, IRS cannot ensure that its outstanding obligations and disbursements do not exceed available budget authority.

Financial Reporting

While IRS demonstrated significant improvement in the form and content of its financial statements during fiscal year 1999, IRS still lacks adequate internal controls over its financial reporting process to provide reasonable assurance that its financial statements are reliable. As a result, IRS was unable to reliably report the components of its net position and unable to prepare reliable statements of net cost, changes in net position, budgetary resources, and financing. We found the following.

- IRS' general ledger (1) did not always use the standard federal accounting classification structure, (2) was not current or accurate, and (3) was not supported by adequate audit trails for P&E, program costs, federal tax revenue, federal tax refunds, or taxes receivable. Consequently, IRS continued to be unable to rely on its general ledger to support its financial statements.
- Underlying detail records supporting transactions in the general ledger were inaccurate. For example, in testing a detailed list supporting accounts payable, we found that the list was both incomplete and included invalid items. Specifically, 10 percent of the items we tested from this list were not valid accounts payable, and 20 percent of items we tested from other sources were inappropriately excluded from this list.
- The costs of IRS' two largest programs, customer service and compliance, are intermingled on its statement of net cost. The costs reported for these two programs for fiscal year 1999 include amounts for activities that we believe are inconsistent with the nature of the programs. For example, IRS included funding for customer service activities such as taxpayer walk-in service and taxpayer education efforts in accounting for and reporting costs of its compliance activities.[15] Similarly, IRS considered all non-face-

[15]See *Tax Administration: IRS' Fiscal Year 1999 Budget Request and Fiscal Year 1998 Filing Season* (GAO/T-GGD/AIMD-98-114, March 31, 1998)

to-face contacts with taxpayers forms of customer service, including compliance-related activities such as telephone tax collection and correspondence examinations of tax returns. We found that in 11 percent of the cases we reviewed, staff working on activities that included correspondence examinations or telephone tax collections charged all of their time to customer service. Consequently, IRS is unable to reliably report to the Congress or the public the appropriate information on the cost of either of its two largest programs.

IRS' financial statements are affected by material amounts that are either not recorded in the general ledger until the subsequent year or not recorded at all. As a result, IRS' general ledger is perpetually materially incomplete and must be supplemented by extensive analysis and material adjustments to recognize transactions that were omitted from the general ledger. These supplemental procedures are costly, labor intensive, prone to error, and typically require several months to complete. This approach also requires effective internal controls if it is to produce reliable information. However, IRS did not effectively supervise this process to ensure that errors were caught and corrected before they adversely affected the financial statements. For example, we found material discrepancies in IRS' records that, had we not brought them to IRS' attention, would have resulted in an error of over $102 million on IRS' financial statements going uncorrected. As a result of these problems, IRS cannot produce reliable agencywide financial statements or financial performance information throughout the year as a management tool, as is standard practice in private industry and some federal entities.

Because of the weaknesses and issues discussed above, we continued to find that IRS' financial management systems did not substantially comply with the Federal Financial Management Systems Requirements (FFMSR),[16] federal accounting standards, and the *U.S. Government Standard General Ledger* (SGL) at the transaction level. These weaknesses also indicate that IRS cannot accumulate and report the full costs of its activities on a regular basis as required by federal accounting standards.

Remaining Financial Management Issues

IRS continues to be plagued by serious internal control and systems deficiencies that hinder its ability to achieve lasting financial management improvements. IRS acknowledges the issues raised in our audits, and the Commissioner and Deputy Commissioner of Operations continue to

[16]FFMSR are a series of requirements produced by the Joint Financial Management Improvement Program to improve federal financial management through uniform requirements for financial information, financial systems, and financial organization.

pledge their commitment to addressing these long-standing issues. IRS has a number of initiatives under way to try to address many of the systemic weaknesses, including efforts to modernize its organizational structure and information systems. These efforts appear to be heading in the right direction.[17] Additionally, progress continues to be made on the serious computer security issues we have reported for several years.

We have assisted IRS in formulating corrective actions to address its serious internal control and financial management issues by providing recommendations over the years, and we will continue to work with IRS on these matters. We recognize that IRS' financial management systems were not designed to meet current systems and financial reporting standards. We also recognize that IRS' problems did not occur overnight and that it will take years for IRS to fully correct its systems-related deficiencies. However, we believe that continued progress in resolving a number of the serious internal control issues that IRS faces can be addressed in the near term through continued dedicated efforts on the part of IRS management. Additionally, successful implementation of IRS' longer term efforts and resolution of the serious problems that continue to be identified by our audits will also require substantial management commitment, resources, and expertise.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions.

Contacts and Acknowledgements

For information about this testimony, please contact Gregory D. Kutz at (202) 512-9505. Major contributors to this testimony include Steven J. Sebastian, Charles R. Fox, Joan B. Hawkins, Doreen S. Eng, John H. Davis, Sophia Harrison, and Paul Caban.

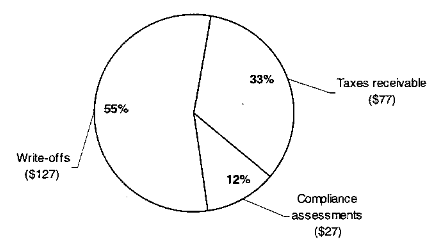
[17] See *IRS Restructuring Act: Implementation Under Way but Agency Modernization Important to Success* (GAO/T-GGD-00-53, February 2, 2000).

Appendix I

Components of IRS' 1999 Unpaid Assessments

Figure 1: Components of IRS' $231 Billion of Unpaid Assessments: FY 1999

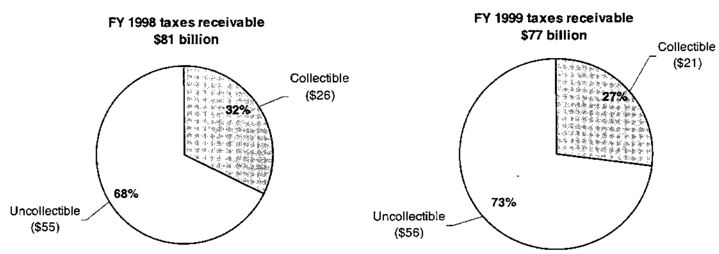
(Dollars in billions)



Appendix II

Comparison of IRS' Taxes Receivable Between 1998 and 1999

Figure 2: Estimated Collectibility for IRS' Taxes Receivable: Fiscal Years 1998 and 1999 (Dollars in Billions)



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Mr. HORN. Well, thank you very much. As you know, we practice letting all of the witnesses speak and then we take questions. So, we hope everybody is going to be here this morning.

That was an excellent document and we have quite a few questions that are going to come from it.

We now have Mr. Lawrence W. Rogers, the Acting Chief Financial Officer for the Internal Revenue Service. He is accompanied by Mr. John Dalrymple, the Chief Operations Officer, and Mr. App, the Deputy Chief Financial Officer of the Treasury. So go ahead, Mr. Rogers.

STATEMENT OF LAWRENCE W. ROGERS, ACTING CHIEF FINANCIAL OFFICER, ACCOMPANIED BY JOHN M. DALRYMPLE, CHIEF OPERATIONS OFFICER AND COMMISSIONER OF THE WAGE AND INVESTMENT OPERATING DIVISION, INTERNAL REVENUE SERVICE

Mr. ROGERS. Thank you, Mr. Chairman. We have submitted my testimony for the record, and I have a short summary of that.

Mr. HORN. Just take your time. You are a principal witness. So automatically, all of your statements go into the record once we introduce you. But feel free.

Mr. ROGERS. Yes, sir. I will give you a short summary of that and then we will turn to questions. My testimony is for Mr. Dalrymple and myself representing the IRS.

Mr. Chairman and distinguished members of the subcommittee, I am pleased to testify today on GAO's report on our financial 1999 audits. I would introduce Mr. Dalrymple whom you have already mentioned. Mr. Dalrymple is the Chief Operations Officer for IRS.

This year, due to the combined efforts of the IRS and GAO teams, GAO was once again able to render an unqualified, or clean opinion on the IRS statements of custodial activity, as has been noted by Mr. Kutz, and represents $1.9 trillion that IRS collected in tax revenues in this past year.

That being said, we are very disappointed that we were unable to achieve an unqualified opinion on our administrative actions. I can assure you that this was an effort, an all-out effort, by the agency to improve; and I am going to talk later about the improvements that we were able to achieve.

The IRS believes the GAO report is generally accurate. In its report, GAO staff expressed concern about the IRS use of labor-intensive, compensating work-arounds. In fact, really, during the audits that we have, it requires a cooperative effort by the GAO teams and ourselves to carry out these audits; and we will have to continue with these types of work-arounds for the near term, that is, until we are able to replace the archaic Legacy data systems that IRS now uses to track its tax collections. With these improvements, though, that we have made during the past year, we believe we can sustain the progress that we have achieved and do this while we are seeking more fundamental system improvements.

I would like to spend a couple of minutes talking about our improvements over the past year. We were able to overcome the loss 2 years ago of a mass migration of supervisors out of our system, out of our accounting system, and we have replaced all of those people. They are trained and in place. This is one of the issues that was brought up in last year's report by GAO, and these folks are there and are working very well.

On the custodial side, we have improved the data extract process by which the audit is done. In 1999, IRS staff was able to assume responsibility for analysis of the financial classifications for accounts receivable. We were also able to perform collectibility analyses of receivables, and this was work that the GAO teams previously had to perform before we were able to come up to speed and take over some of that workload.

On the administrative side, the fund balance was reconciled with Treasury at the end of fiscal year 1999, and I think the GAO notes that in its report, although expresses some concern. But we think that we have gotten there, and in fact, we are continuing to reconcile the cash balance each month, and we have done that for October and November of fiscal year 2000. A new permanent team is now charged on a recurring basis with that duty. I will tell you that I personally check on that every month, just to make sure.

IRS also cleaned up the suspense account to a reasonable level and the appropriate entries were made to record the clean-out of that account.

We are providing for this coming year to make a subsidiary ledger for our accounts available which will enable us in the future to give GAO cleaner extracts for audit purposes. In addition, we put into effect procedures that the IRS will follow to ensure sustainability of our property evaluation figure from the end of our fiscal year 1999. This process will remain in place until a more permanent solution is found.

Also of interest to the GAO and the subcommittee, we continued to improve on an aggressive security management program which focuses on identifying, managing and mitigating security weaknesses. We also have established the financial and management control of the executive steering committee, and that committee is chaired by the deputy commissioner to strategically manage and improve on initiatives and ensure that appropriate controls are an integral part of the IRS programs.

We view these steps and numerous others that are described in detail in our written statement as necessary investments. These investments have to be made so that IRS can meet the statutory policy requirements for good financial data that fairly presents the status of IRS finances to all interested parties. We did this to the best of our ability in 1999, and we will continue to do so from here on.

Mr. Chairman, in the long term, the inadequacies in and solutions to our financial reporting systems must be addressed through the broader efforts under Commissioner Rossotti to modernize both the systems, technology and organization of the IRS as mandated by the landmark IRS Restructuring and Reform Act of 1998. I want to thank you, and if Commissioner Rossotti were here, he would certainly do this as well, for the leadership that you have provided from this subcommittee, especially in the area of computer systems and the Y2K process. In the interim, we intend to develop the best financial data possible while continuing to concentrate on the more complete reform of the data systems.

I can assure you that we will sustain each of this year's improvements. We will work toward a financial management system that fulfills the requirements of the various acts; and also in the longer run perhaps—and I think this is what Mr. Kutz is saying—will provide IRS managers with the data they need to operate the agency effectively and efficiently.

Thank you very much. We would be glad to answer any questions that you may have.

[The prepared statement of Mr. Rogers follows:]

TESTIMONY OF
LAWRENCE W. ROGERS
ACTING CHIEF FINANCIAL OFFICER
INTERNAL REVENUE SERVICE
BEFORE THE
HOUSE COMMITTEE ON GOVERNMENT REFORM
SUBCOMMITTEE ON
GOVERNMENT MANAGEMENT, INFORMATION AND TECHNOLOGY
IRS FISCAL YEAR 1999 FINANCIAL STATEMENTS
FEBRUARY 29, 2000

INTRODUCTION

Mr. Chairman and distinguished Members of the Subcommittee, I am pleased to be able to testify on the General Accounting Office's report *IRS' Fiscal Year 1999 Financial Statements*. Accompanying me today is IRS Chief Operations Officer and Commissioner of the Wage and Investment Operating Division John M. Dalrymple.

Due to the combined IRS and GAO efforts, we are pleased that the General Accounting Office once again rendered an "unqualified" opinion on the IRS' Statement of Custodial Activity. Our intense and unwavering efforts over the past several years resulted in a clean opinion on the $1.9 trillion that the IRS collected in tax revenues last year.

That being said, Mr. Chairman, we are obviously disappointed that we were unable to achieve an unqualified opinion for our Administrative accounts. However, we believe that the IRS staff made great strides from the unacceptable situation in which the IRS found itself at the end of FY 1998 and remedied a large number of deficiencies.

IRS also fully understands that much of the success we achieved in gaining the unqualified opinion on the Statement of Custodial Activity was reached through labor intensive processes. We greatly appreciate the cooperative nature of the assistance that we received from the GAO teams to make this approach possible. However, until we are able to replace the archaic legacy data systems now in use, we must perfect and continue to use these procedures. There is, unfortunately, no other alternative.

GAO's FINDINGS

The IRS believes that the GAO report is generally accurate. In its report, GAO expresses concern about IRS' use of labor intensive compensating workarounds. We understand that concern, but with the improvements that were made during the past year, we believe that we can sustain our progress while seeking more fundamental system improvements. There is a basis, in fact, for a positive outlook in this matter.

In response to the many issues contained in the GAO's draft report, we prepared a number of page-by-page comments that were submitted to the GAO and are part of its final report. We listed the corrective actions taken on the material weaknesses/reportable conditions/noncompliance with laws and regulations as well as other significant matters. We believe that these comments are important to understanding the extent of our efforts and our commitment to further improvement.

Mr. Chairman, we are working hard to achieve an "auditable" set of financial data in the immediate years ahead, while tackling the overall, long-term problems associated with retooling the very complex and outmoded record keeping systems that currently exist for tax administration.

In fact, IRS' ability to achieve all of its short- and long-term goals and objectives depends largely on reliable financial information and effective management controls. For this reason, IRS has established an executive steering committee to strategically manage improvement initiatives and ensure that appropriate controls are an integral component of all IRS programs.

The Financial and Management Controls Executive Steering Committee (ESC) uses a risk-based management approach, similar to the one that has been used successfully in other arenas, such as Y2K, Taxpayer Treatment and Service Improvements, and Business Modernization. This approach is predicated on ensuring prompt decision making and on facilitating cross-functional coordination.

The ESC is chaired by the Deputy Commissioner Operations and includes Treasury's Deputy Chief Financial Officer, IRS Chief Officers, the Associate Chief Counsel (Finance and Management), the Chief, Agency-Wide Shared Services, and the National Treasury Employees Union (NTEU) President. After they become fully operational, the four new customer-focused operation divisions will be represented on the ESC.

We see many of the steps the IRS took in Fiscal Year 1999, and those listed in the Appendix, as not only related to the current year's audit, but an interim investment to produce reliable information, while we continue to build the systems that will provide longer-term solutions to the IRS financial systems issues. Many of the actions resulted from our agreement with GAO's findings in past years. Following are some of the highlights.

We overcame the loss of CFO managers that occurred two years ago; our new team of supervisors is now in place. On the Custodial side, we improved our data extract process, and in 1999, were able to assume responsibility for analysis of the financial classifications for accounts receivable. We were also able to perform "collectability" analyses of receivables – work that the GAO teams performed until IRS staff was capable of taking over the duties.

On the Administrative side, the fund balance was reconciled with Treasury at the end of FY 1999, and monthly reconciliations have now occurred for October and

November of Fiscal 2000. A new permanent team is now charged on a recurring basis with the function. IRS cleaned up the suspense account to a reasonable level, and the appropriate entries were made to record the clean out of the account.

We are also working to provide a subsidiary ledger to our accounts, which will enable us in the future to give the GAO "cleaner" extracts for audit purposes. In addition, we put into effect procedures that the IRS will follow to ensure sustainability of our property valuation figure from the end of FY 1999. This process will remain in place until a more permanent solution can be achieved. Also of great interest to GAO and the Subcommittee, we implemented an aggressive security management program, which focuses on identifying, managing and mitigating security weaknesses.

We view these steps, and numerous others, as necessary investments by IRS to meet the statutory and policy requirements for good financial data that fairly presents the status of IRS finances to all interested parties. We did this to the best of our ability in FY 1999, and we will continue to do so from here on.

Mr. Chairman, I want to address other GAO's findings, that merit clarification or more detail. GAO and IRS have both been concerned about computer security issues. GAO reported it again this year as a material weakness, although the report does identify the improvements that the IRS has made in this area. We agree that it continues to be correctly reported as a material weakness, but it is also important to note that Commissioner Rossotti has decisively moved the responsibility and authority for all computer operations under the direct control of the Chief Information Officer.

In that office, two former GAO executives, with experience in information technology security, have directed an energetic computer security program. This has been an office which does not just wait until GAO or other auditors identify issues, but is actively pursuing its own program of security improvements while also concentrating on those identified by our auditors. I believe that, while we have much more to do, GAO would recommend the current IRS approach to other agencies.

GAO also identified many instances in which accounts that appeared to have some collection potential were not being actively pursued. Their report goes on to state that IRS designated these accounts as "currently not collectible."

IRS' decision to modify the criteria under which unpaid assessments could be designated as "currently not collectible" was resource driven. We are not able to actively pursue all cases with currently available resources. Therefore, we gave priority to addressing the more current "high dollar" cases that show the greatest potential for collection. We believe this is a necessary and sound business decision.

More fundamentally, as Commissioner Rossotti has testified, the IRS collection approach needs to be reengineered in accordance with generally known best practices and technology. The IRS devotes 90 percent of its collection resources to accounts over six months old, when commercial experience shows that the likelihood of collection is low.

In addition, this delay increases the cost in interest and penalties to the taxpayer and makes it harder for the taxpayer to settle the debt. The delays associated with potential enforcement action then come into play and can prolong the process by as much as another year.

A key long-term goal of reengineering the IRS collection process is to shorten the time before an IRS employee contacts the taxpayer, by phone or in person, when there is a significant risk that a tax debt may not be paid, to resolve the issue as quickly as possible. The new modernized organization structure provides the management structure necessary to integrate the management of collection operations, and to manage the reengineering of the process and all underlying technology.

GAO further states in its report that the matching of W-2s and information reporting does not occur at the time the returns are processed because it is not practical due to the intensive labor involved. To make an up-front match now would conflict with the IRS' mandate to promptly process tax returns and issue refunds in the interest-free period of 45 days.

Mr. Chairman, the statement is correct, but while the task was difficult before, beginning in the year 2000, RRA 98 granted payors an additional month for filing information returns if these documents are filed electronically. This additional time, while providing us with better documents, also unfortunately, under certain circumstances, further inhibits our ability to implement GAO's recommendation.

GAO's discussion of Earned Income Tax Credit (EITC) examinations also merits important additional information. The draft report states that EITC examinations are "...often performed after any related refunds are disbursed, examinations cannot substitute for effective controls..."

The IRS does freeze refunds on EITC returns it believes display the highest potential for error. Last year, we performed more "pre-refund" than "post-refund" audits and the facts speak to this. Of the 573,000 tax returns examined in FY 1999, approximately 70 percent were pre-refund audits. In other words, IRS examined over 400,000 EITC returns before it issued any refund due to EITC.

An example of a return receiving post-refund audit treatment would be one where more than one taxpayer is claiming the same qualifying child for EITC. At the conclusion of the audit, the taxpayer who is not entitled to the credit is billed for the underpayment and the taxpayer's file is marked so that EITC cannot be claimed in a subsequent year without the taxpayer re-certifying eligibility for the credit. For the 2001 filing season, we plan to have the Dependent Database match in place. That will allow us to perform pre-refund audits of these duplicate Taxpayer Identification Number cases.

With regard to the excise tax distribution process, we would like to point out that, as GAO states in both FY 1998 financial audits, IRS is dependent on a "complex, error-prone process for determining revenue distributions." The GAO also made a similar comment in the FY 1999 financial audit. We believe that is a fair description but would note that it flows from the fact that taxpayers are required to remit payments earlier than they are either able or required to remit assessment information.

However, GAO's discussion of the reporting and distribution to trust funds for this fiscal year does not recognize all of IRS' efforts to attain more accurate data. During FY 1999, the IRS added two additional analysts to support the review/certification process of excise taxes. Check sheets, which are subject to managerial review/approval, were also developed to ensure the quality of each excise tax certification. In addition, procedures were established to provide post-input controls to review certain returns with assessments of one million dollars and over and to review all returns reporting coal tax assessments of five hundred thousand dollars. This means that the IRS is reviewing over 92 percent of the total dollar value of excise tax assessments.

It is also significant that in June 1998, IRS changed from certifying based on liabilities to certifying based on collections, making it important that tax returns post timely to ensure the accuracy of the certified amounts. To address GAO's concerns regarding amounts reported from previous quarters in current quarter certifications, the IRS revised its procedures to ensure expedited posting of the returns.

These procedures have resulted in marked improvements. However, the reporting from previous quarters will continue to occur because of amended returns, audits and late filing of returns subsequent to the certification period. Additionally, there is currently no penalty for filing a late return if the taxpayer makes timely deposits, although we continue to monitor these taxpayers and request their returns.

GAO's statements relating to installment agreements also need clarification. The IRS Assistant Commissioner for Collection issued a memorandum in March 1998 stating that any new installment agreement given to a taxpayer must provide for full satisfaction of the taxpayer's liability. Prior to this time, the IRS had accepted a number of installment agreements that would not fully pay outstanding and accruing liabilities over the terms of the agreement.

The revised procedures that were adopted in March of 1998 prohibit entering into an installment agreement that does not fully satisfy the liability over the term of the agreement. Errors occurred during the transition to this new procedure but we have taken steps to eliminate future mistakes. Thus, in addition to the memorandum that was issued providing instructions, the Internal Revenue Manual was subsequently revised to include this change in procedure.

Lastly, the GAO points to our problems related to the current system of property and equipment inventories (P&E). The GAO states, " IRS relies on individuals across the country to inform those responsible for maintaining the subsidiary records of any P&E additions or disposals."

GAO fairly characterizes the situation. However, during this audit period, and as part of the decision to have a one-time valuation of P&E done by a contractor, IRS reviewed its efforts to improve and maintain a good property management system. We will be implementing shortly an internal procedure to maintain the benchmark from the sample valuation.

In the future, through the implementation of the Single Point Inventory Function (SPIF), we will have on-site teams in field locations to review procurements on the Requisition Tracking System (RTS), ensure their delivery on site, and ensure proper disposition and removal from inventory system. The SPIF procedure will be used to improve both the Integrated Network and Operations Management System (INOMS) and the Property Assets Tracking System (PATS), and will continue in place until an integrated property management system is installed as the overall financial management system is replaced.

LONG-TERM SOLUTIONS

Mr. Chairman, in the long-term, the inadequacies in, and solutions to our financial reporting systems must be addressed through the broader efforts under Commissioner Rossotti to modernize both the systems and organization of the IRS as mandated by the landmark IRS Restructuring and Reform Act of 1998.

The key to better financial management at the IRS is improved technology. Chairman, I want to thank you, as Commissioner Rossotti would do if he were here today, for your leadership and support in this critical area, and especially for what we learned from attacking the Y2K problem.

Commissioner Rossotti recently testified before the subcommittee that our success to date on Y2K yielded several important long-term residual benefits. These included replacement of obsolete hardware and systems software products; improved program management practices; standardization of products; and improved inventory management.

The latter is of particular relevance to today's hearing. GAO has criticized the IRS for the poor condition of its Information Technology inventory, but because of our Y2K efforts, we were forced to examine our inventory as never before. The condition of our inventory is now greatly improved although much work remains to be done.

Many of the solutions to the IRS' problems can only be found in new or enhanced automated systems, and this is a vast, complex and risky undertaking that will require many years to accomplish. The IRS must replace nearly its entire inventory of computer applications and convert its data on every taxpayer to new systems. It must be accomplished in conjunction with redesigned business practices as part of our overall modernization program, while continuing to provide service to taxpayers and to respond to ongoing tax law and other changes.

Mr. Chairman, in the interim, we intend to develop the best financial data possible, while continuing to concentrate on the more complete reform of the data systems. I can assure you that we will sustain each of this year's improvements. We will simultaneously work toward a financial management system that fulfills the requirements of the various acts and also provides IRS managers with the data they need to operate the agency effectively and efficiently.

Mr. HORN. Mr. App, the Deputy Chief Financial Officer for the Department of the Treasury.

STATEMENT OF STEVEN APP, DEPUTY CHIEF FINANCIAL OFFICER, U.S. DEPARTMENT OF THE TREASURY

Mr. APP. Mr. Chairman and members of the subcommittee, good morning and thank you for inviting me here today to discuss financial management in the Department of Treasury and the Internal Revenue Service.

Throughout fiscal year 1999, the reporting cycle senior management, including the Assistant Secretary for Management and CFO, as well as the IRS Deputy Commissioner, have provided critical oversight to improve the audit results at IRS. Mr. Chairman, that is a commitment we made to you last year. Across Treasury, we are pleased with the progress that we have made on financial reporting and the sole qualification this year on our report will be the IRS administrative statements.

Working with our audit partners and the IRS, we hope to strive for unqualified opinions in 2000 at both the IRS and the Treasury. It should be noted, however, that the path to improved short-term audit results at IRS will remain labor-intensive for the next few years until the core financial and management systems can be reconfigured or replaced.

The Department's management fully recognizes the leadership role that main Treasury must play in sound financial reporting, and we will continue to support the IRS efforts to sustain the progress made during fiscal year 1999, to strengthen the CFO structure and management team at the IRS, and to build the financial systems needed to improve reporting and, more importantly, the management of IRS resources.

To that end, the Department is actively engaged with the IRS on longer-term system solutions. Also, we made needed changes in CFO leadership at IRS. You have heard from my colleague, Larry Rogers. Larry Rogers has demonstrated throughout Treasury his leadership ability, has tackled the jobs of starting the Inspector General Office at IRS, as well as filling in the permanent leadership at the Inspector General. The Department and IRS and GAO have all recognized Mr. Rogers' capabilities, and I think they are demonstrated by the results this year. Going forward, our collective goal is to win the war for top financial talent at IRS, both by selecting a strong, permanent CFO and strengthening the CFO office.

While freely acknowledging the financial reporting problems at IRS and the negative impact on the Department, I would like to conclude my remarks by pointing out three areas of steady progress across Treasury. First, in terms of timeliness, we expect to meet the March 1st statutory deadline for the Department for the first time in Treasury's history. The Secretary is signing the reports today, as well as the Inspector General, and we hope to deliver them to OMB today.

Second, for fiscal years 1997 through 1999, as you have already heard, Treasury has received unqualified opinions on its primary governmentwide functions: collecting revenue and also managing the public debt. GAO is again rendering unqualified opinions, as you have heard, on the revenue of $1.9 trillion at IRS, as well as public debts, $5.7 trillion in debt. Also, the rest of the Department's bureau and custodial activities, with the exception of IRS, all have clean audit opinions, no department-level audit qualifications.

Finally, a last point is that the nonpayroll, IRS administrative accounts that have been the focus of the GAO reporting problems this year largely have a negligible impact on the status or opinion of the governmentwide financial statements, due to their low level of materiality.

Mr. Chairman, that concludes my testimony. I would be pleased to respond to any questions you may have. Thank you.

[The prepared statement of Mr. App follows:]

EMBARGOED UNTIL 10:00 A.M. EST
Text Prepared for Delivery
February 29, 2000

DEPUTY TREASURY CHIEF FINANCIAL OFFICER STEVEN APP
HOUSE COMMITTEE ON GOVERNMENT REFORM
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT

Mr. Chairman and members of the Subcommittee, good morning and thank you for inviting me here today to discuss financial management in the Department of the Treasury and the Internal Revenue Service (IRS). Throughout the fiscal year (FY) 1999 financial reporting cycle senior Treasury officials, from the Department's Assistant Secretary for Management and Chief Financial Officer (ASM/CFO) to the IRS' Deputy Commissioner, have provided critical oversight to improve the audit results at the Internal Revenue Service (IRS) -- a commitment we made to you a year ago.

While we are pleased with the continued progress that has been made across the Treasury Department, both in the timeliness and quality of our FY 1999 audit results, the remaining financial reporting deficiencies on the IRS administrative accounts have resulted in the sole qualification of opinion on the Department's FY 1999 Accountability Report. That said, we are encouraged by the General Accounting Office's (GAO's) reported findings of progress in seven areas of financial reporting at IRS, particularly the progress made on the balance sheet. Working closely with IRS, and our audit partners in the GAO, the Treasury Inspector General, and Treasury Inspector General for Tax Administration (TIGTA) offices, we intend to build on these positive, albeit incremental, results and strive for unqualified opinions at both the IRS and the Department as a whole for the FY 2000 financial reporting cycle. It should be noted, however, that the path to improved, short-term audit results will remain labor intensive for the next few years, until core financial and management systems can be reconfigured and/or replaced.

Department management fully recognizes the leadership role Treasury must play in sound financial reporting and will continue to support the IRS efforts to sustain the progress made during FY 1999, strengthen the CFO structure and management team within the IRS, and build the financial systems needed to improve both financial reporting and, more importantly, management of IRS resources.

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To that end, the Department is actively engaged with the IRS on the longer-term, systems solution that will have the precision and automated capabilities to sustain the financial reporting gains of FY 1999 and the next few years. Further, needed changes were made in CFO leadership at IRS over the course of the FY 1999 reporting cycle, installing a highly qualified Treasury executive, my colleague Larry Rogers, as the Acting CFO at IRS. Mr. Rogers has a demonstrated track record in leading other Treasury organizations including the Treasury OIG and TIGTA until permanent leadership was in place, and the Department, IRS, and GAO recognized his capabilities during the FY 1999 IRS audit. Going forward, our collective goal is to win the war for top financial talent at the IRS, both by installing a strong, permanent CFO and strengthening the CFO office to optimize financial reporting and management.

While freely acknowledging the continuing financial reporting problems at the IRS and the negative impact on the Department's FY 1999 opinion, we would like to point out the steady progress made across Treasury. This progress has been made both on the timeliness and quality of results.

First, in terms of timeliness, we are proud of meeting the March 1 deadline for the first time this year, delivering the FY 1999 Treasurywide and three required standalone bureau reports from our revenue bureaus, IRS, Customs, and Alcohol, Tobacco, and Firearms, to the Office of Management and Budget by the statutory due date. This achievement demonstrates Treasury's continued commitment to timely, accurate financial reporting, having incrementally improved the delivery date each year, since preparing our first Accountability Report for FY 1995.

Second, since FY 1997 and continuing through FY 1999, Treasury has received unqualified opinions on its primary governmentwide functions -- collecting revenue and managing the public debt. GAO is again rendering an unqualified opinion for the third year in a row on IRS' revenue collection activities of $1.9 trillion dollars and the Bureau of Public Debt's federal debt management activities of $5.7 trillion dollars. Further, with the aforementioned, notable exception of IRS' administrative accounts, the rest of the Treasury bureaus custodial and administrative accounts had no Departmental level audit qualifications.

Finally, it should be noted that the non-payroll, IRS administrative accounts that are the focus of the FY 1999 reporting problems, have a largely negligible impact on the status or opinion of the Governmentwide financial statements -- due to the relatively low materiality level vis-à-vis the aggregate Federal Government activities.

That concludes my testimony and I would be pleased to respond to any questions you may have now or later. Thank you.

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Mr. HORN. Gentlemen, we are going to now conduct the questioning. It will be 5 minutes per member, and we will alternate between both sides of the aisle. Let me just start with a couple of questions.

On pages 30 and 31 of the GAO report, at the bottom of page 30, it notes taxes collected on behalf of the Federal Government are deposited in a General Revenue Fund at the Department of the Treasury from which they are subsequently distributed to the appropriate trust funds. Now, this is a question I have asked numerous times in the last 6 years, and I still am concerned about it.

Here we are: Amounts representing Social Security and hospital insurance payroll taxes are distributed to their respective trust funds, based on employee wage information certified by the Commissioner of the Social Security Administration.

What I would like, Mr. Rogers, is for you to tell me in simple English for the average taxpayer that might read this transcript some day, are we really getting all that we should be getting from payroll taxes? Because over here in footnote 29, GAO recently reported in detail, unpaid payroll taxes: billions in delinquent taxes and penalty assessments are owed, August 2, 1999.

Now, that is what has been worrying me for 6 years, that we don't quite put the money that comes in as an excise tax from the employer that is deducted, half of the Social Security wage and the person's additional half. We just seem to have economists that say, yes, I guess that is right, and Social Security administrators say, apparently, that is right.

I don't believe it. Isn't there a simple way, in an age of digital analysis and sweeps in a grocery store, we could have sweeps in an excise tax as it comes in and gets it right and puts it in the right trust fund? We now have the lockbox, at least out of the House, and we are going to make enough noise on that lockbox on Social Security that no President, regardless of party, and no Congress, regardless of party, will be dipping their hands in it. But I am worrying about the stuff that never got in there to start with.

So what can you do to reassure us?

Mr. ROGERS. I think I can assure you, Mr. Chairman, that money that is collected for the trust funds does go through the general fund, but into the trust fund itself. I think in looking at a stream of information over time and the way the taxes are collected, there will be some occasions when employers who have collected the money and were holding it in trust never paid it. That is, they went out of business or something happened that the money is not collected.

So when you look at a long-term stream, some of this money won't get collected; it just will never get there.

However, the certification process calls for the Social Security Trust Fund basically to be made whole. I think it has been referred to as a subsidy by GAO, but in fact it is the way Congress and the government have chosen over time to make sure that all people whose Social Security benefits have been withheld, it is guaranteed that way.

So I think there will always be a small loss.

The issue, I think, for IRS is to do the best job it can to collect the money from those people who do not pay; and that is the primary administrative issue that I think we face.

Mr. HORN. Now, that M.D. that you cited with a case, was that part of his problem that he hadn't paid payroll taxes?

Mr. ROGERS. I have not seen that case. I would have to ask Mr. Kutz.

Mr. KUTZ. That was individual income taxes, a 1040.

Mr. HORN. It had nothing to do with office employees or anything?

Mr. KUTZ. No.

Mr. HORN. I think we have found, when you look at all of these cases across the country, you often have nonprofits that usually hang by the nails anyhow, and the first thing they don't report to the IRS is their wage deductions from their employees, and they use that to keep running the information.

Mr. KUTZ. Right. As we reported to you last summer, unpaid payroll taxes are the No. 1 enforcement issue at the IRS. Indeed, as Mr. Rogers pointed out, the amounts that go into the Social Security Trust Fund—despite the fact that these payroll taxes aren't collected, the trust fund is indeed made whole, which creates a built-in subsidy, and that is in accordance with the law; but the subsidy we reported in this report is about $43 billion over time.

But we do continue to see a number of unpaid payroll tax cases in our samplings as part of the fiscal 1999 audit. We found again that there were officers that were responsible for starting up and shutting down business after business and not paying over their payroll taxes. We have a number of examples of those that we can share with you if you would like.

Mr. HORN. I will get into that on my next question, but I will yield now to the gentleman from Texas, the ranking Democrat and the ranking member, Mr. Turner, for questioning.

Mr. TURNER. Thank you, Mr. Chairman. Please excuse me for being late today. In fact, I would like to submit my opening statement for the record.

Mr. HORN. Sure. It will be put right after mine and put as if read.

Mr. TURNER. I want to followup on the question you were pursuing, Mr. Chairman.

This problem of unpaid payroll taxes, it seems to me that there ought to be some examination of ways to improve upon that, to include ideas such as, perhaps, what would be the effect if you required a $200 deposit by everyone who applies for an employer identification number, to be refunded after successfully paying your taxes for 1 year, or something like that? You know, how much would that generate in terms of savings?

I mean, are we talking about people, Mr. Rogers, who don't even apply for an employer identification number, or are we talking about people who do apply for one, but end up being delinquent in their payroll taxes? I guess if they never apply for one, you don't know about them, do you?

Mr. ROGERS. I think that is right. I think that you are on the right track.

Mr. TURNER. So what would be the financial impact of requiring a $200 deposit at the time you apply for an employer identification number? Would that be helpful?

Mr. ROGERS. I think $200 seems like a small amount and probably most employers who are entering into the market could do that. It brings with it all of the administrative issues of any situation like this where the government would have to record it, you know, take care of it, put it into an escrow account, pay it back at some point when they went out of business. So there is always a hidden cost that becomes very real when you start trying to administer something like that.

I think you and Mr. Rossotti were engaged in a discussion about this earlier, and I think his view was that you have to kind of balance off the impact and the burden on employers or people who are trying to startup who may be, you know, eking out a beginning and whether this would have an impact on them. I don't know that $200, frankly, would be high enough to be good, earnest money; it might need to be higher.

Mr. TURNER. I think Mr. Rossotti and I talked one time about the effect of requiring a bond by those, and perhaps a bond could cover a much larger amount of unpaid liability. Not knowing anything about the potential market for that kind of proposal, I don't know what the bond could cost an employer, but obviously we need something to make some inroads on the large amount of unpaid payroll taxes.

Mr. ROGERS. To some extent, though, one of the problems is the number of outfits that go out of business. The bankruptcy laws in this country are such that there is a limit on what you can get back from a bankrupt company. So there is going to be a residue along the way of a loss on payroll taxes; and especially for Social Security, I think the issue is, how do the country and the government ensure against that?

As was said earlier, I don't view this as a subsidy, but sort of a self-insurance program that the government has put in place to make sure that this very important account, Social Security, is kept whole.

Mr. KUTZ. Congressman Turner, let me just mention one thing on this.

As you may recall from our hearing last summer, the individuals and businesses that we are talking about here, that don't pay payroll taxes, many times are receiving other Federal benefits, such as SBA loans, Navy contracts, et cetera. So that is another issue. It is even worse than just not paying the taxes, that these same individuals and businesses are benefiting from other programs within the Federal Government, which is another issue that needs to be looked at.

Mr. TURNER. I just have the feeling that there are probably some solutions here that both of you could help us fashion, as long as they weren't unduly burdensome on the business community. It seems to be an area we should pursue. After all, we are talking about taxes, half of which are actually the funds that belong to the employees who work for those businesses; so it doesn't seem to me to be totally unreasonable for us to have some—at least a little bit stronger enforcement ability to collect those moneys that actually belong, at least half of it, to those employees.

I want to pursue a little different line of questioning and perhaps, Mr. Rogers, you could help me on this. I understand that Secretary Summers has embarked upon an examination of corporate tax shelters; and I don't know if the GAO audit in any way touched upon that subject, but is it true—at least it seems to be what I have read recently in press reports—that corporate income tax revenues to the IRS are down?

Mr. ROGERS. Yes. I am not sure of the figures, but I think they have dropped from 26 percent of their corporate income to, I believe the figure is 22 percent over the past few years; but we would have to get the exact figures for you. That is in the face of the percentage payment by individuals going up. They are going in different directions.

Mr. TURNER. So the fact that the percentage of total collections by corporate entities is down from 26 to 22 doesn't mean that the actual total dollar collections by corporate taxpayers is down?

Mr. ROGERS. I don't think so, but I think the rise in the economy and the total tax collections is lifting everything, even though the proportions have changed.

Mr. TURNER. It was disturbing when I read that article in the sense that we all have the impression that the economy is booming, and you would certainly think corporate income tax payments would be on the rise, as are individual tax payments, as a result of the good economy. So it was somewhat troublesome to me to see that.

It seems to me to address maybe a broader problem that I would expect you to have an opinion on, and that is this issue of whether or not many of the problems that we are hearing about today can be traced back to the complexity of the Internal Revenue Code, which every year that passes in our efforts here in Congress to provide additional provisions to, in many cases, induce good conduct by our taxpayers, we have new provisions that taxpayers have to deal with and the IRS has to deal with.

I would be interested in your view as to whether or not much of the difficulty you face in administering your agency could be traced back to the very complexity of the Code itself, and thus, the issue could be raised of whether or not we should be talking more about simplicity or simplifying the Code.

Mr. ROGERS. I am not sure I am ready to give an opinion on simplifying yet, but I think we can state the facts here.

The comparison, the analogy has been made that the Internal Revenue Code, in words, is larger than the Bible. I think that the number of changes in the last couple of years with the reform act amounts to 800 law changes in the Code. In an agency that is trying to collect taxes and implement that number, that magnitude of changes, it obviously makes it difficult.

I recall that you said that you still do your own taxes, as I do myself, and even from a personal standpoint, this is something that is pretty daunting. I feel like I am pretty well informed on it.

So I think the complexity affects everybody. It affects the administrative apparatus of an agency like this. We have to deal with a very large economy, with a lot of people, a lot of activity going on;

and the changes and the complexity make it very difficult. There is no doubt about it. I think at this point, though, I am really not prepared to speak to whether we need some broad simplification or something of that sort. I think this is an issue that is much broader and greater than I am prepared to deal with today.

Mr. HORN. I have given you your opening statement time. Go ahead.

Mr. TURNER. Thank you.

Let me just ask as a followup. The problem that Secretary Summers is wanting to address in terms of the increasing utilization of tax shelters by the corporate community, isn't that a direct reflection of the fact that the Code has become so complex that the corporate community and their tax advisors and attorneys are doing things that really you in the Internal Revenue Service don't have the ability to even look at to determine whether or not they are complying with the law or not?

Mr. ROGERS. Well, I think the identification of this problem is a result of looking at these tax shelters, and the examination of large companies like this. I mean, I am going to ask Mr. Dalrymple to help me here in a minute; but I think that the companies would say that the tax system exists, it is there, and that they are entitled really to look at it and use it to their proper benefit.

I think the issue that is in debate right now is whether or not some of the companies may have pushed that limit a bit beyond good practice; and that is what Mr. Summers has been taking on as an issue and has been discussing here on the Hill.

Mr. HORN. Mr. Dalrymple, do you want to add to that?

Mr. DALRYMPLE. The only thing I would add is that what Mr. Summers has been talking about, of course, is abusive tax shelters; because tax shelters, in and of themselves, there is nothing wrong with them. Everyone shelters their income legally and should, because that is what the law is all about. But the real issue is whether there is a real economic base or economic reality to the transactions.

As Mr. Rogers correctly stated, we have uncovered these through examination. They are very, very complex issues when we uncover them. They take a tremendous amount of effort to uncover them. The idea behind the regulations, of course, is to ensure that these shelters are identified as the returns are being filed by the taxpayers, so that they are easily identified and they are returned and, therefore, are sort of basically an open book policy.

Mr. HORN. Well, I thank the gentleman for those additional facts. I just thought that maybe we ought to have only a "last year" for every Presidential term, and then they finally get around to doing the right thing. So the first 3 years, they milk the cow for elections and then the last year they do the public interest. So I am all for having maybe 4 last years for everybody from now on.

The vice chairman, the gentlewoman from Illinois, Mrs. Biggert, 5 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman. If I might also ask unanimous consent to put my opening statement into the record.

Mr. HORN. It will go right after Mr. Turner's, and we will give you some additional time on questioning.

Mrs. BIGGERT. Thank you. My first question is for Mr. Kutz.

What we have been debating in Congress over the past few months has been the issue of privacy. I wanted just to ask about that. Certainly, there is sensitive information about an individual in the IRS. I am wondering whether, since the management practices, is there any compromising of that information?

I am disturbed by reports stating that the IRS is lax in protecting sensitive taxpayer information. Do you agree with that concern? Is that a concern?

Mr. KUTZ. Yes, it is a concern in two areas. No. 1, the area of computer security which—as Mr. Rogers said earlier, IRS has a very proactive program in that area where they go out and do self-assessments and identify various computer security issues. They still have a lot of challenges in that area to resolve.

The issue we are most concerned about at this point is the delay in the responses of the fingerprint checks where employees are going into the service centers and handling taxpayer data, checks, cash, and various other information before IRS receives the fingerprint results back. What has been found in the past and what we have reported is that some of these various individuals have stolen information and committed fraud with it. So we are very concerned.

We believe that the IRS policy should be that these individuals should not be allowed into the service centers or anywhere else to handle this information until satisfactory results of fingerprint checks are received.

Mrs. BIGGERT. Thank you. Do you think that there is any need for congressional action on this issue?

Mr. KUTZ. That is pretty much a management issue in our view, and I think it is something that IRS should be able to address and get around the various administrative issues they have in actually implementing it. I think last year we had this same discussion before this subcommittee, and IRS was going to have that problem solved by last summer, and they don't have it solved at this point as far as we have seen. It is something that needs to be done.

Not only do they have electronic fingerprint issues, and then they have basically the ink blot at some locations that they are still using for fingerprint checks. I think that both of those issues need to be streamlined before employees are allowed to go into service centers and handle this information.

Mrs. BIGGERT. Mr. Rogers, I assume that you spoke about this during your testimony, but I am sorry I missed it, if you could just comment briefly on that.

Mr. ROGERS. I am going to ask Mr. Dalrymple to answer this question. This is strictly an operational and management issue.

Mr. DALRYMPLE. I believe it was 3 years ago actually, and this is part of a much broader context in terms of security, physical security, at our service centers in which the GAO was very helpful in terms of pointing out some specific issues that we needed to address. As you talk about privacy and access to confidential information, very confidential information, sensitive confidential information, I believe 3 years ago most of our controversy at the time was around browsing that we had by employees; and we have solved that problem.

In addition to that, the GAO pointed out other deficiencies that we have also addressed, and I think they would be Johnny-on-the-spot to say that we have addressed a number of the physical security issues. We have taken the ability for people to take handbags and hats and things into processing areas; we have put lockers outside of those areas so that people have to put their personal belongings in there so that they can't easily take checks or other confidential information out of those areas.

In addition to that, we had a process in place prior to that audit where our background investigations took so long that by the time our—most of these are temporary employees that come in during our filing season. By the time our background investigations came back, the employees were actually off roll, they were no longer working for us.

Now we have an arrangement with the FBI where we get data back where there are no hits within 3 days, and on average, we are getting information back within 8 days. Our current policy is not to have those folks, until their background investigations are completed, be in our remittance processing organization or our receipt and control organization.

Now, what I will say is that during our very peak days, 2 or 3 days where we have tremendous amounts of mail coming in, and we are recruiting and hiring right up through April 15th, 17th, 18th, when tremendous amounts of mail come in, we do have to make some decisions on whether or not we are going to make—get the mail open and get deposits in the bank on a timely basis, or not. And a lot of that depends on how many people are available, how many hands.

So what I am saying here is that I can't completely commit that we wouldn't have to use some people who we don't have the checks back from; but the bottom line is, we get the checks back in time to find out whether or not we have people with a record and that we can take action before they have left our rolls.

Mrs. BIGGERT. Do you think that 3 days for fingerprints or 8 days for completion of a background check is soon enough? I mean, we certainly have been able to do that faster with criminals now, with the instant background or the instant check.

Mr. DALRYMPLE. Well, these are the instant checks that we are getting through the FBI now. So I am not sure that we can cut that timeframe any closer, although frankly, we are trying to do—especially on the cases where we have hits for the 8 days. I think, getting them back within 3 days doesn't pose too much problem because the training and orientation that goes on when you hire a new employer takes 1 day, and getting the information back within 3 allows us to productively employ them before we put them into sensitive areas.

Mrs. BIGGERT. Just changing gears a little bit, Mr. Rogers, some of my constituents who work for the IRS have contacted me in recent months about the agency and the working environment, and I think this is all part of what has been happening. They say that really the morale of the IRS is declining due to the recent well, congressional reforms, is the way they put it. I don't know if it is the reforms, but trying to change the practices or whatever.

Have these concerns been raised to you? Do you see a situation where people are down, so to speak?

Mr. ROGERS. Well, I don't know about down. I think Commissioner Rossotti has spoken to this issue on several occasions and perhaps before this subcommittee. The agency is undergoing massive change, and the reorganization, the restructuring, is a big one. It is an incredible change in government circles about the way this agency does business. And moving from the traditional regional/territorial kinds of organizations to functional groups like this is almost unprecedented. It is a change, I think, which the Commissioner endorses and which the Congress has asked the agency to undertake. When you have that kind of change, I think it is inevitable that people are going to be very concerned.

There is also the overlay of the 10 issues that were in the Reform Act, and the concern that people have had that they might be fired. I mean, those 10 issues, it moves personnel actions away from the traditional civil service system of appeals and safeguards to one of dismissal without review, except by one person. That is a major change as well.

I think the implementation of those provisions, however, has been done correctly and clearly employs "must knowingly violate" these things; and if you look at the issues there, if an employee had knowingly violated them, they would have been terminated previously.

But until everyone gets comfortable with this new environment, I think there will be concern. It is a big change that is going on, and this overlay I think clearly will create concern on the part of any rational employee. But I don't think—you know, you look at the record here this year, again, all of the forms went out, the taxes got collected.

You know, there are issues on the margin that we need to deal with in the under-reporting and the taxes that haven't been collected. But in fact, the agency did achieve its basic purpose; it got the money in, got it reported on, and as the GAO said, that part of the agency's financial statement received an unqualified opinion, which I think is a tribute to people who are working in the place under these conditions.

Mrs. BIGGERT. Mr. Kutz, have you seen any changes in the environment since the reforms or your investigations?

Mr. KUTZ. I would say overall that many of the people are very inspired by the Commissioner, I would say the new Commissioner—I guess he is not that new anymore. But the one area, we talked to enforcement and collections people across the country as to the payroll tax work we did for you last summer—and we testified before you last summer—and I think we found and heard a change in the culture and atmosphere within some of the people in the collections and enforcement area where "enforcement" was kind of—almost a bad word to some extent.

We did find an example of a case this year that I will have Mr. Sebastian—just to give you an idea of the kind of environment that you may be dealing with at this point.

Mr. SEBASTIAN. This was actually an unpaid payroll tax case where the business had accumulated a number of quarters of delinquent taxes. The IRS had actually assessed several officers a trust fund recovery penalty for the employee-withheld but unremitted amount. One particular officer had a total unpaid tax assessment of $4 million. The IRS had actually exhausted all other attempts at collection and had seized a condominium owned by this taxpayer.

Exactly 1 day prior to auction, the property was pulled from the potential sale and later released and returned back to the then deceased taxpayer's spouse. The indications in the revenue officer case files were that the IRS did not want to have an "open seizure" on an internal control report.

In our report, we characterized this as "no reasonable explanation" because the truth of the matter is, aside from the explanation I have just given you, there is nothing in the case file that would indicate why the IRS didn't go forward and sell this property.

Mrs. BIGGERT. So that was just written up as a loss then?

Mr. SEBASTIAN. At the end of the day, yes.

Mr. KUTZ. That was revenue that the Federal Government would have otherwise collected had the seizure gone through.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. HORN. I will now yield myself 5 minutes and maybe a couple more to equal both of you.

Getting back to that Social Security situation, on page 31 you talk about how the Federal Government's general fund revenue subsidized the Social Security and Hospital Insurance Trust Funds. A lot of us thought Social Security was subsidizing everybody else with Presidents, both Democratic and Republican. Where is that money coming from in the general revenue into the Social Security Trust Fund?

Mr. KUTZ. I will let Mr. Sebastian handle that one. This is his area.

Mr. SEBASTIAN. Well, essentially, I think we have probably gone through this in prior sessions. All revenues that are collected are initially going into the General Revenue Fund of the U.S. Government, where they are then distributed into the various trust funds such as Social Security and Hospital Insurance. The distribution, the initial distributions to the Social Security and Hospital Insurance Trust Funds are based on estimates of wage information that is conducted by the Social Security Administration's Office of the Chief Actuary. Roughly 9 to 12 months after that initial distribution, when actual wage information is obtained by both the Social Security Administration and the Internal Revenue Service, the Social Security Administration Commissioner will certify based on that wage information the amounts that should have been transferred into the Social Security and Hospital Insurance Trust Funds. The Treasury's financial management service will affect any adjustments needed.

So the bottom line is, the revenue is coming in throughout the course of the year. It is initially being distributed based on estimates, but at the end of the day, it is being adjusted for the wage information. There is really no relationship between that and the amounts that are actually collected for Social Security and Hospital Insurance. In fact, the IRS currently doesn't have a mechanism for measuring the actual amounts that are collected for Social Security and Hospital Insurance taxes.

Mr. KUTZ. So to the extent you have unpaid payroll taxes, that is where you have a subsidy to the Social Security and possible Medical Insurance Trust Funds.

Mr. HORN. How many billions of dollars in subsidies from taxpayers are generally put into the Social Security Trust Fund?

Mr. SEBASTIAN. Are you talking about on an annual basis? Because the number that we actually present here is cumulative, with some caveats; there are some expired accounts that are not considered. But roughly it would probably be a couple of billion dollars a year.

Mr. HORN. Just a couple of billion?

Mr. SEBASTIAN. A couple of billion a year.

Mr. HORN. You are saying it is chicken feed then?

Mr. SEBASTIAN. Over time it adds up.

Mr. KUTZ. On an annual basis, yes. Several billion, probably.

Mr. HORN. Since I sit on the Transportation Committee, let me ask you about the Airport Improvement Fund and about the Interstate Highway Fund. Do they have that subsidy also from the taxpayers?

Mr. SEBASTIAN. A different situation there in that, by law, the Highway, Airport and Airway Trust Funds receive distribution based on actual revenue collected. The IRS has the same problem there in that, as receipts are being paid over the course of any given quarter, the IRS cannot attribute a receipt with a specific type of tax. So, initially, excise tax receipts are distributed into the various trust funds based on an estimation process done by Treasury's Office of Tax Analysis.

Roughly 6 months after any given quarter as the IRS receives and processes tax returns, it matches tax return information against the actual collections for those taxes, and using the tax return, the IRS certifies the amounts that should have been distributed to the trust funds based on type of tax. It is really not until they process the tax return that they can equate the dollar collected to the specific tax type. Even then, it is still somewhat an estimation process.

Mr. KUTZ. But it is an estimate of what is collected, not what should have been collected.

Actually, I have the information. The Highway Trust Fund received $39.3 billion during fiscal year 1999, and we did audit work on that for the Transportation Inspector General. The Airport and Airway Trust Fund received $10.4 billion during fiscal year 1999. Again, this is for all of the various types of taxes. With the Highway, there are 16 different taxes that go into that trust fund, and with the Airport and Airway there are six different taxes that go in.

Mr. HORN. Well, does GAO have any recommendations that would make this more accurate than having estimators? I still don't see in this age when a gasoline station is deducting the pay and it is going into a huge corporation, the thousands of stations that might be under, say, Chevron or Mobil or Texaco, and they are going to send on whatever basis—quarterly or monthly, I have forgotten how that is handled by IRS—but it just seems to me with that you have so many cents off the gallon, that is to go into the Federal Treasury and into the trust fund, and the same with when I fly on my little trip every other week to California, I have a little excise tax when I land at certain airports. So that, it seems to me, can automatically be put into right fund and you don't need an estimator.

Mr. KUTZ. You would have to require the taxpayer when the money comes in to tell the IRS basically what each piece of the deposit is for. The money comes in in a bulk amount for excise taxes and the payroll taxes, and you would have to have them report up front.

What you could probably do is, at the back end, relieve some of the other requirements that they have, such as the quarterly filings. You maybe could have them file annually their payroll taxes and excise taxes; if you required them to tell you every 2 weeks—because they make deposits every 2 weeks, the big companies, if they were to tell you every 2 weeks how many dollars of each deposit goes where.

I don't know if Mr. Rogers has anything to add to that, because the IRS actually has done a study last year where they looked at this issue.

Mr. HORN. What did they find, Mr. Rogers, when they looked at the issue? Here you have a bunch of people we are paying salaries to called estimators, Ph.D.s in economics from the Ivy League, I assume. We don't need that. Why do we? Why don't we just get it accurately from the person that is deducting the money and shipping it to you?

Mr. ROGERS. It would shift the burden to taxpayers to provide more information at this point, the way the tax structure is set up. But the process here is one of doing an estimation, and there are not many people that do it. I am going to guess maybe 4 or 5 or 6 people in our office; this is not a big operation. The estimates basically allocate the money at the outset, and then you correct it when the tax returns come in each quarter.

When you have an income stream, having an estimate and an adjustment like this is not, in and of itself, dangerous. I mean, it is something that, as you go along, might be the most efficient way to do it, as opposed to putting more burden on taxpayers. They come in, and the emphasis here is on collecting the money. People who run weekly payrolls provide money every week, people who do biweekly, every 2 weeks; and that money is coming in, it is in the government's hands and it is available for the government to draw interest on, so that you have it in hand. I mean, that is what withholding is about and that is what these quarterly payments are about.

So the emphasis has been, over time, get the money, get it in circulation and have the government get the interest on it, and then adjust as the returns come in quarterly; and I don't know—the study shows it would be a burden and my guess is that employers might resist it.

Mr. HORN. Might resist? You mean we would have tax resistance?

Mr. ROGERS. No. Having a change in the tax.

Mr. HORN. Believe me, we would have it if Bierdly Rummel hadn't dreamed up withholding. This country wouldn't be past 2 percent when you get to the end of the year, there would be a tax revolt from one end to the other.

Mr. ROGERS. Well, again, that is the emphasis that Congress put on it is to get the money to pay as you go, and that part of it I think is working very well.

Mr. HORN. Well, I only wish the taxpayer, when IRS is wrong, would get their amount back with interest. Now, have we adjusted that?

Mr. ROGERS. Yes. There is a 45-day requirement that we make refunds and after the 45 days, then we begin to pay interest on it. I think there has been discussion about that before, and the mandate to get the refunds out in time so that people who are owed them don't suffer by having them kept here.

Mr. HORN. Last year, as I remember, we had some felons that had been hired by IRS, and this gets back to the security issue. Here you have, as I understand it, you have where the money flows into these service centers, we have surrounding fences, security guards, metal detectors, yet GAO reported that someone somehow was able not only to get into the service center, he was handed a $28 million deposit without even asking for identification, just because he was wearing a courier uniform, even though the security guards and the staff that handed him the deposit didn't know him. How could something like that happen?

Mr. DALRYMPLE. Well, it shouldn't have happened like that. They should have asked for his identification when he came in. That is the procedure.

But what happened was exactly the way he described it. He came in in the courier uniform of the courier that picks up deposits, he was an employee of the courier, he came in in the courier vehicle; he parked where he was told to park, where the couriers are always asked to park; he went in, he got the receipts as the couriers are supposed to do; and he left. What they did not do is they did not confirm his employment with that courier, and they should have done that.

Mr. KUTZ. This gets into the issue of how difficult it is to enforce policies at the IRS. You have so many offices around the country that IRS can have certain policies in place, but it is very difficult to enforce them across the board. I know Mr. Dalrymple knows how difficult that is for the IRS.

Mr. HORN. Mr. Turner.

Mr. TURNER. Mr. Rogers, back on the subject of simplification of the Tax Code, does the IRS have a computer model in place that would give the Congress access to the type of information one would need if you seriously wanted to go about the task of trying to simplify the Tax Code? For example, if Congress wanted to take a look at how many taxpayers are utilizing a deduction for educational expenses that the Congress has in the law and we want to see how many people are using it, what is the revenue loss as a result of people using it, do you have the ability to turn around that kind of information quickly?

Mr. ROGERS. I don't think there is a model of the type that I think I hear you conceiving of, where you have everything set up and you could just change a variable and it would give you a new answer. There is not a model of that sort, I am confident in saying.

However, one of the things that IRS does traditionally is analyze proposals that are made and provide information of what the impact would be one way or the other. I think that were there some specific suggestions of that sort, that the agency could respond with studies or analyses of what they would consider the impact to be.

Mr. TURNER. So you routinely do analyses of proposals, but in terms of just looking back and seeing how a certain deduction is being utilized, who is utilizing, what income categories of taxpayers are utilizing that deduction, those kinds of things you really do not have the ability to provide that kind of information?

Mr. DALRYMPLE. We actually do quite a bit of that through our Statistics of Income Division in conjunction with the Office of Tax Analysis at the Treasury Department and in conjunction with the Joint Committee on Taxation here on the Hill. By no means is it every item, but there is a great deal of work done every year on particular items, specifically around credits, what they have done, how they have been used, what the impact has been.

So as Mr. Rogers said, it is more specific than general, but there is quite a bit of that work that is done.

Mr. TURNER. If we were to undertake seriously a project to simplify the Tax Code—and of course you know in the House there was a bill that passed that would sunset the Tax Code, thus forcing a complete review of the Code—would there be suggestions that you would make to the Congress in terms of getting the data in better shape for that kind of an analysis than we have today? Would there be things that would need to be done prior to a serious review of the Tax Code?

Mr. ROGERS. I think it really depends on the nature of the proposals. Sort of "simplifying" is kind of an attractive word, but as we were talking about earlier, this is a huge undertaking. I think it would really depend on the nature of the proposals to be able to react to something like that. This is a hard area.

Mr. TURNER. I guess my concern is that as we hear these reports from the GAO about the difficulties that the IRS has in administering the Code, the difficulties in collection, we hear reports from Secretary Summers about perhaps the stretching of the utilization of tax shelters, you know, it seems to me that we are going to come to the point where the general public begins to sense that there are a lot of folks that are not paying their fair share. And as we all know, the ability to collect taxes is based, in large part, on the basic honesty of the American people right now; their willingness to try to comply is critical.

I am concerned that, over time, we are seeing an erosion of the public's confidence in that. Unfortunately, I think from time to time the Congress contributes to that with their own rhetoric, but it does seem to me, after reading this GAO report, that there are many things that certainly would cause a taxpayer to lose confidence in the collection agency and would contribute to one's general sense that perhaps some other folks aren't paying their fair share and, therefore, I don't think I ought to have to pay all of mine. At some point, it seems to me that we are going to have to try to deal with that, do something about that.

Now, you have watched this a lot longer than I have, Mr. Rogers, and maybe you would disagree with me and not be concerned about that; and I would be interested in your observations.

Mr. ROGERS. No, sir, Mr. Congressman. I am concerned about it, but I think that we—if you look at the GAO report, it sort of breaks down into some financial issues and some management issues. In my estimation, most of the management issues in here are things that this agency can control over the longer run, or even the shorter run. I mean, the whole issue of couriers and talking about that—that went wrong and it shouldn't have—and I hope—you know, we can say that the guards have been dealt with, trained and retrained. So when you sort of split this and look, we didn't pay some bills, this sort of thing; but when you look at tax collection, you are right.

I mean, it is amazing. I was looking at some data today before we came up here, and 180 days past the point at which taxes are due the outstanding tax liability that is unpaid is less than 1 percent on personal income taxes. I mean, people do comply, and what we are looking at is the difference in trying to pinpoint those issues that deal with collection.

The subsidy issue that has been raised by the GAO, the $43 billion that is subsidizing Social Security, well, that is a 10-year accumulation; so on average, it is $4.3 billion a year, and 65 percent of that, the penalties and interest. The taxes are quite small that people didn't pay.

So we get focused, you know, on this, and we miss the bigger piece, which is this system is working pretty well and people do come up here and people—tax shelters, I mean the Secretary is concerned about that, so there is a situation where people are not doing everything they should. We ought to do something about it; I think you are right.

In fairness to everybody in this country, everybody ought to be paying their taxes. But the system is working pretty well now, and I think when we look at these isolated instances, we lose sight of that, frankly.

Mr. KUTZ. Congressman, let me mention one thing with respect to that, because I think the issue is even bigger than what Mr. Rogers said, because what we are talking about with—the $231 billion in unpaid taxes, for example, is what IRS knows about. There is still the issue of the remainder of the tax gap out there, which includes the underground cash economy, illegal activities, et cetera; and that is something that IRS, GAO and nobody really knows how substantial that is. But that is also a consideration in what you are talking about.

Mr. TURNER. It certainly is.

Thank you, Mr. Chairman.

Mr. HORN. The gentlewoman from Illinois, Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Along this line, but just going back to focus on the $23 billion of taxes owed, Mr. Kutz, could you talk a little bit more about the collectibility of these dollars and about the issue of that amount of money?

Mr. KUTZ. Yes, I can. In the inventory of unpaid assessments at September 30, 1999, there is $231 billion of total unpaid taxes. Of that, there are pieces called write-offs, there are pieces called compliance assessments, and then there are the gross and net taxes receivable.

What you see up on the poster board to my right are the taxes receivable for fiscal years 1999 and 1998, and those are accounts that either the taxpayers acknowledge that they owe, or the IRS has a favorable ruling that a taxpayer owes the amount; and you will see there the actual collectibility rates of, and I guess 32 percent and 27 percent.

So that is the amount of collectible out of the actual receivables amount.

The write-off amounts that we are talking about are primarily failed businesses, individuals who have passed away with no estate, et cetera. So those are the ones that don't have a whole lot of collectibility. But what really is on the table as unpaid taxes that IRS has a chance to collect, what you see on the poster board is what really is most likely to have some potential down the road.

Mrs. BIGGERT. Thank you. Mr. Rogers, in your testimony you stated that the IRS is not able to pursue all of the cases, and that the IRS thought it was a necessary and sound business decision to modify its criteria as to which assessments would be designated as uncollectible. Could you explain how you came up with that decision?

Mr. ROGERS. Yes, ma'am, and I am going to ask Mr. Dalrymple to help me in a moment. One of the things I would like to do is put this a little bit in perspective.

The $77 billion is basically a 10-year accumulation. I think it is not unfair to average this, and you are really talking about $7.7 billion per year in a system that collects this year $1.9 trillion. So if you look at this as kind of a corporate enterprise, any corporation of this size and not knowing who its customers are and whether they are creditworthy or not is going to have some loss in collecting its bills.

So when you begin to analyze that and decide where you are going to put your effort with an agency that, by and large, still is working full out, you do have to make some decisions like this. And we have done that, and John will walk you through how we do that.

Mr. DALRYMPLE. We have prioritized work for as long as I have been with the Service, and I have been with the Service for 25 years in terms of our collection work and what has been described in the GAO report is the prioritization of our work. It is clear that with the resources we have to work collection accounts, there is a certain amount of work that we would do in particular ways, such as through our notice activities, through our automated collectionsites, and then eventually through our field activities.

We have a system in place that is somewhat risk-based, so that it is certainly not where we want to go with the risk-based collection activity. But the bottom line is, we do some risk analysis on this inventory and we determine whether or not it is worth our pursuing with the resources we have available to go after that particular account. In these instances, we felt that it was not; that there were other higher-priority types of work.

In business trust fund cases, a perfect example, we wanted to give those a very high priority. So we have determined these cases to not be collectible at this time. They are currently not collectible, which does not mean they are not collectible. It means we put them in a suspense account. We systemically monitor them. Any offsets to refunds would be taken against these accounts. Liens are filed on some of the accounts, depending on the value of them. Again, taxpayers who want to extinguish the lien have to come back and satisfy the liability. There are a number of systemic things that happen on these accounts.

So when we say "currently not collectible," that is exactly whether we mean, as opposed to—as Mr. Kutz referred to earlier, these are not considered write-offs at this point.

Mrs. BIGGERT. Mr. Kutz, it seems to me that some of this might be a case of lost opportunity, and particularly after hearing from Mr. Sebastian of a case that was written off the day before the end of the year so that it won't show up. What do you think about that?

Mr. KUTZ. Well, these are lost opportunities in many ways. The $2.4 billion that Mr. Dalrymple was talking about that was taken from the collection inventory had some potential collectibility. The $10 billion of potential unreported taxes due, that IRS was unable to pursue, had potential to be collected to some extent.

They also do a matching program for, I guess it is called a "combined annual wage reporting program," and they get $600,000 or so discrepancies in that program and that program has not been funded and they haven't done anything with those 600,000 matches, so there is potential there.

There are also the cases like the doctor case that I gave you in my opening statement that are sitting in the inventory as unassigned case, that are not being worked; and that was clearly an individual that has the means to pay the taxes due.

So I think that there is a substantial number of opportunities. As Mr. Rogers said, if you look at the bigger picture and say 1.9 trillion, it is not significant compared to that, but are billions or tens of billions of dollars significant? Yes, I think so.

Mrs. BIGGERT. Since it becomes a trillion, I guess the saying goes——

Mr. DALRYMPLE. Congresswoman, if I could address this particular case, since it has come up a couple of times here, it is—when I saw this case, I decided to personally look into this, because I was somewhat concerned about the report; and as it turns out, this case was a case with a clouded title, and that is why the case did not go to auction. Our counsel actually advised against selling this asset at auction and advised the manager of that. So there was very good reason that this case didn't go to auction.

Mrs. BIGGERT. It had a clouded title over and above some of the tax problems?

Mr. DALRYMPLE. Exactly, exactly.

Mrs. BIGGERT. Do you know what that was?

Mr. DALRYMPLE. I really can't get into the specifics of that here, but suffice it to say that there was a clouded title on this case.

Mrs. BIGGERT. Thank you.

Thank you, Mr. Chairman.

Mr. HORN. Was there political intrusion at all on that case?

Mr. DALRYMPLE. No, there was not.

Mr. HORN. So nothing in the files?

Mr. DALRYMPLE. Not that I have seen.

Mr. HORN. OK. The predecessor to Mr. Rossotti as Commissioner and I had a discussion in probably early 1995, and I looked at the $100 billion sitting around that was not being collected, and she then said, oh, I have another $60 billion which could be collected. I must say when I look at that receivable for 1999 and we have $21 billion collectible and we have $56 billion uncollectible, I ask myself, is any of that, the $60 billion she talked about in 1995 and the $100 billion they were just letting go. It just seems to me, as I told her, it was a national scandal as far as I am concerned.

Then we had the Debt Collection Act in 1996. It doesn't really apply to the IRS, right?

Mr. DALRYMPLE. Actually, it does this year. The taxes are part of that effort starting this year.

Mr. HORN. You make me feel better. As I remember, Secretary Rubin did care and did use it, whether it was authorized by him or not.

Mr. DALRYMPLE. We actually believe that, through your efforts, that that is going to be a significant event for us.

Mr. HORN. Well, that is good. I am glad. That will make me feel good. We are going to have an extra panel and you will probably be back there again on the debt collection situation. We know that there are bankruptcies in there and all the rest of it, but there has to be some way that when people in the audience and everywhere else across the country are paying their taxes and these people go in and out of bankruptcy and it is a pattern and practice, I think something ought to be done about it. I think we ought to get that money somewhere down the line.

Does the Treasury have any bright ideas on this?

Mr. ROGERS. I think the one thing I would do, Mr. Chairman, is add some analysis about what the receivables look like if you could go to the $21 billion. Mr. Chairman, 43 percent of that is the result of insolvent corporations. Another 30 percent are financial hardship situations where the IRS has pursued collection from an individual and has come to the conclusion that there is nothing left there, the assets have been seized, they have no income, so there is just no reason to keep going. Another 3 percent represent people who are deceased, and another 21 percent are actually bankruptcies, and a small 3 percent are people that we are unable to locate.

In other words, while it is sitting there and it looks like you could do it, there are really pieces of this that make it difficult to do; and I think it goes to the whole issue of collecting this kind of debt.

I was looking this morning before we came up here in trying myself, because I am relatively new to this part of the Treasury Department, and I was looking and thinking about $1.9 trillion. If you have a 1 percent loss in a year of $1.9 trillion, that is $19 billion. So these are big amounts, and I think the most important thing from my perspective, in going back to Congressman Turner, is the whole sense of fairness. That is, while these are relatively small figures, I think it is important that the agency be in a position to collect everything that is due, that we fairly do that, and that we make that case to the public.

Mr. HORN. Are we using private collectors to help collect some of this?

Mr. ROGERS. No, sir, we are not. I think—as you know, that was tried, and I was not here and I can't speak to it too thoroughly, but I think—the Commissioner and I were talking about this again yesterday. The view here is that we have to fix this system to get to these debts sooner, and that if we go through the process of giving the four notices and then the due process that was put in under the reform act, the restructuring act of giving it a 30-day due-process notice and a due-process decision, we really are way down the stream of time before these debts are really something to be collected. And if the agency, and even a private collector, could get to them in a year or two, that is too late. I think that is what he is saying too.

Mr. HORN. Well, if you are thinking of the private collector pilot program, that was the phoniest thing I have ever seen in government. They wanted it to fail. They gave them 5-year-old debt, instead of getting them in on the act in 30 days, 60 days, whatever. And the IRS, at least in 1995, was not in any way organized to collect anything.

Mr. ROGERS. I think that is the problem that the people in IRS face themselves. They are trying to collect that ancient debt, that old debt like that; and again, the Commissioner is trying to reform the system so that we have a computer system that will let us get close to that 6-month period at which the private sector is paying. If you let it age more than that, you are going to lose it. But again, we are looking at the compliance issue.

On the margin, the numbers here relative to all of the taxes that people pay voluntarily that comes in, that is huge, and yet the compliance is very high and within 180 days, the outstanding debt is less than 1 percent.

Mr. HORN. When you look at that chart, that compliance isn't very high?

Mr. ROGERS. Yes, sir, but again that is, on average, $7.7 billion a year, which is about—it is less than one-half of 1 percent of the collections last year.

Mr. HORN. It is a lot of money.

Mr. ROGERS. It is a lot of money. I don't want to take away from that. But to get enough people and enough money in an agency to collect everything down to perfection would make this an extraordinary expensive agency to run.

Mr. HORN. Well, I would sure like to see you organized on getting the notices out, getting some telephone contact, and then if that hasn't worked in a month or two, give them to private people, and they will do it if IRS hasn't been able to do it. Maybe the Commissioner has some new special task force that is doing this somewhere, but I wish you would take an area where you have had a lot of bankruptcy, whatever, and try to track those people. We have to put a law on the books, or something, so that they don't keep milking us when everybody else is paying and these jerks are going out of business.

Well, I wish the Treasury would come in with something on a proactive area, not just sort of live with it and say, gee, that is 1 percent. I don't care if it is 1 percent, if it is $21 billion, I have a concern about it.

Mr. ROGERS. Yes, sir, and you are right. The compliance issue here and the fairness issue here is paramount. It is very important.

Mr. HORN. Well, you know, one of the reasons people pay taxes is, they think the IRS really follows this stuff, and now you look at that, you wonder who is working over there. I know you dropped from 108 to 102. What are you now in total employees, 102,000?

Mr. ROGERS. The 2001 budget request would be about 102,000.

Mr. HORN. Are we going to get some new agents?

Mr. ROGERS. Yes, sir. The budget request calls for increased staff in almost every function, except the information technology, and there are funds being requested to improve the computer systems.

Mr. HORN. It was mentioned that a lot of supervisors left last year. Was that just a matter of quality of supervisors, or what led to their going?

Mr. ROGERS. I am the one who mentioned that. No, the GAO pointed out that there was a management problem in not having adequate managers trained to run the accounting shop, if I could put it that way. This is a group of about, well, less than 200 people out of all of the IRS, and 5 of the top supervisors at one time all left and took jobs at the Department of Agriculture. It was to their advantage; they saw this as something they needed to do for their own personal good. On the other hand, it left IRS in a bit of a lurch, so that we had to catch up.

We had to get people there, get them trained and make sure that that part of the agency was working right, and I can report to you that it is at this point. But it was a gap. I mean, I think some of the issues that GAO ran into last year, and specifically I would say, the failure to reconcile the cash balance with FMS, with the Treasury Department, is directly attributable to that. And so we have overcome it, but that is a singular, isolated incident.

Mr. HORN. Mr. Kutz, it says, as I recall, that the IRS does run some automated matching programs, and I understand they are run months after the issuance of tax refunds and they don't investigate all of the taxpayers identified in having underreported tax liabilities. Don't you report—out of the $15 billion identified as potentially being underreported, the IRS only investigated $5.2 billion; is that correct?

Mr. KUTZ. That is correct. And the other $10 billion that you are speaking of would not be included in the unpaid taxes. That would never have been assessed or followed up on. It would have basically been removed from the files or nothing was done with it.

Mr. HORN. Well, does this basically mean the individuals and businesses that are reflected in that 9.8 billion, that they got away without paying their fair share of the taxes?

Mr. KUTZ. To the extent that those 9 million individuals, I believe, or 10 million—I think it was 9 million actually—really owed those taxes and actually underreported income; yes, that is correct.

Mr. HORN. Well, is that a 1 percent deal, or is that something we ought to worry about?

Mr. ROGERS. I think it is something we would worry about, but I think John will tell you that we are trying to pick those cases through a winnowing process that are most likely to be the ones that we need to do.

Mr. DALRYMPLE. I think the numbers were 155 million individual tax returns originally filed, and as we looked at those accounts, we saw about 12 million that had some potential for running through our underreported matching program. We then looked again to determine what we considered to be the very best cases there, so that we wouldn't be burdening people with letters that we weren't certain would result in—that wouldn't result in an error on their return.

So we were pretty confident of the 3.1; we went over those, and we ran an underreported program there. Again, we do not resource the Service to go after every last account.

Mr. HORN. Well, do you still have them under statutory law where you could investigate them on the $9.8 billion that was uninvestigated?

Mr. DALRYMPLE. Each year we run the same matching program. There is a 3-year statute of limitations on how long you can go after those, once we screen a particular year and go after the particular people in that year. So, for example, the 3 million underreporters that we investigated, the other 9 million that we set aside in that year, we do not pursue after that, unless they come up for examination—and some of them would—come up for examination in a regular examination. Then those issues would be raised in that examination, although that would be a very small percentage of that 12 million, in total.

Mr. HORN. I am just thinking of the $9.8 billion.

Mr. KUTZ. Mr. Chairman, one thing I would point out here is that it would be useful for IRS to provide to the Congress the kind of information that you could make good decisions based on, and that would be for every dollar you put looking at these 9.8 million individuals that may have underreported their income, what would you get back in cash from a governmentwide perspective for that? That is the kind of information that you should expect from the IRS, but I don't think you get it at this point, and that is something IRS should work on in the future.

Mr. HORN. Well, this was which fiscal year, Mr. Kutz?

Mr. KUTZ. It was the last fiscal year which they did the underreporting. There is always a delay. It was fiscal 1996, so that was the tax year 1996 which they would do the match in late—late 1997, and probably followup——

Mr. HORN. So the statute of limitations has expired, or what?

Mr. DALRYMPLE. It would have expired this year, yes.

Mr. HORN. It expired this year? Do we still have time?

Mr. DALRYMPLE. April 15th of this year they would expire.

Mr. HORN. Well, not if you did something. You would still do it within the 3-year time period. I just wonder, when you have $9.8 billion that went uninvestigated, I just wonder why we aren't doing something about it. I mean, is somebody afraid that the Portman bill, who said smile, but we didn't say smile on everything. If there are tax cheats, let's go after them.

Mr. DALRYMPLE. Absolutely, Mr. Chairman.

Mr. HORN. We also reported the Portman bill. So, we are for smiling IRS agents too, but I would smile a lot more if I saw that $9.8 billion pursued.

Mr. DALRYMPLE. Again, as Mr. Kutz pointed out, we have no idea whether that $9.1 billion is legitimate underreporting. All we had were indications that there may be some question on those particular returns. We culled out of the 12 million returns, we culled out 3 million for investigation.

Mr. HORN. Mr. Turner.

Mr. TURNER. Mr. Chairman, I know all of us have been asking questions based on the GAO report and our other concerns about the agency. Perhaps it is appropriate for us to—and I think we all agree on this. There is probably no agency that requires more of its employees than the IRS; it is a very demanding position at any level, and I personally want to commend the agency and its employees. I know—the recent legislative changes, I think, have made improvements. In each of our offices we deal on almost a daily basis with the IRS on behalf of our constituents who have had problems and are seeking our help. I have noticed a very positive change within the agency as a result of the recent legislation and in the leadership of Mr. Rossotti, and I really do believe that we owe all of you a debt of gratitude for the commitment and the service that each of you gives from the very top to the very lowest level, because it is a very demanding job requiring very special people. So we thank you for your service.

Mr. ROGERS. I thank you, Mr. Congressman. And on behalf of Mr. Rossotti and all of the IRS employees, we really appreciate that. As I said earlier, we are doing everything we can to get better. It is not a lack of desire.

Mr. HORN. Well, the reason I am high on Commissioner Rossotti is that he brings some management skills to that job where there had never been any management skills. I don't have a problem with most of the IRS people. I think the problem has been lack of management over there, lack of organization, and I think that is now happening, and that should make everybody happy, the people there and the people here.

Any other questions, Mrs. Biggert?

Mrs. BIGGERT. I guess you all thought that was the end, but I do have one further question.

Mr. Kutz, I recall that last year you had a concern that the property and equipment reported by the IRS could have been materially understated, and given the massive increase in property and equipment reported, that is less than the $200 million in 1998 to $1.3 billion in 1999. Could you elaborate on what you found in your audit?

Mr. KUTZ. Well, what that was is a projection by the IRS using—they had some consultants and appraisers that were involved and part of it was statistical information and part of it was from other information that the IRS put together. But that number—I believe it is the $1.3 billion, or somewhat less than that—is an estimate of what the balance is on September 30, 1999. As I said in my opening statement, the actual underlying problems with the inventory and the accuracy of it is an issue IRS faces for fiscal year

2000. So that number is just a number at a point in time that was developed for the purposes of the financial statements.

Mrs. BIGGERT. So, Mr. Rogers, I guess you would agree that the property had been materially underestimated or—unless you purchased $1 billion, or your estimate was really pretty far off?

Mr. ROGERS. No, I think you characterize it correctly. The records did not show a value at that level, and in government property management, there has been a tendency over time to be more concerned about what the article is than what the article costs. And so if you go to inventory systems, you will see the item there, but there is nothing in the cell that says this is the value of it. As a consequence, the value of the property is materially understated, as you have observed and as GAO has identified.

We do believe that the estimate that we derived this year is a fairly accurate and reliable estimate and we worked through this process with the General Accounting Office overseeing it, in effect, or testing it as we went along.

I think the important thing for us now is to make sure that we don't lose that figure; that is to say, we need to maintain this property level in terms of the accounting systems as we go through this year. That is, we need to take every acquisition, value it, every disposal, value it, so that when we come to the end of fiscal 2000 we have a property figure that will reliably tell our stakeholders what our property plant and equipment value is. And we intend to do that. We have worked out a process to do that during the rest of the year, and in the longer run, we will introduce a newer kind of automated accounting office to do that.

Mrs. BIGGERT. So this property was not subject to theft or anything, it was just an underestimate?

Mr. ROGERS. It is all there. I mean, if you could see the appraisal process that went on, it went to every building. There are 600 buildings in IRS. The buildings were selected by random, they went into floor plans, they drew grids, they picked the grids by random collection, they went to that place, they checked if the property was there, they went to the books to see and then went back and adjusted it. So it was a fairly—I don't want to say exhaustive, but statistically it was a good process that gives us a good idea of the value of the place.

Yes, it was undervalued; I mean, the property was there, but the systems used to account for were simply not used fully to attribute the right value to them.

Mrs. BIGGERT. But it still was not a check of every piece of property?

Mr. ROGERS. No. It was a statistical evaluation. On the other hand, the major portion of the property that is valued is the information systems, the computers. And the Information Service Group in IRS has been doing a wall-to-wall, total inventory, front-to-back, and book-to-floor and floor-to-book; and that is the preponderance of the value of the plant and equipment, and that inventory we think will be quite accurate.

Mrs. BIGGERT. So this is, actually the IRS has received so much money for the tax systems modernization, so that will be tracked piece by piece?

Mr. ROGERS. Yes, but only a small portion of the modernization money is directly——

Mrs. BIGGERT. I meant for the equipment part of it.

Mr. ROGERS. Yes, that is directly related to the equipment. There is a fund actually set aside and identified separately for the information technology investment.

Mrs. BIGGERT. Do you know how much the IRS has spent already on the property and equipment related to the tax systems modernization, then?

Mr. ROGERS. No, ma'am, I didn't come prepared to do that, but I could certainly get a figure for you.

Mrs. BIGGERT. All right. If you would do that.

And so you have then tracked all of that property and equipment? That is not done by an estimate?

Mr. ROGERS. On the information and technology equipment? That is correct.

Mrs. BIGGERT. Thank you.

Mr. HORN. We thank you.

Let me just ask a few closing questions here. I am particularly interested in the CFO office for the Treasury. Mr. App, you spoke about installing a permanent CFO, as well as strengthening the CFO office. Could you sort of elaborate on that, what you have in mind, what Treasury has in mind?

Mr. APP. Sure.

Basically, as I mentioned, Mr. Rogers has admirably filled in as Acting CFO, but he, as well as the Commissioner and other officials at IRS, have been looking for candidates to go forward and to strengthen the organization. They have also been looking at alternatives to add responsibilities to that organization, as appropriate, to improve financial management and that is an ongoing process as we speak.

Mr. HORN. Now, Mr. App, you are the Deputy Financial Officer for the Department of the Treasury?

Mr. APP. That is correct.

Mr. HORN. Who is the CFO for Treasury?

Mr. APP. The Assistant Secretary for Management and CFO is now Lisa Ross, who has been Acting since December 30th. We have enjoyed real strong leadership in that position compared to other agencies. The last two people in that position have averaged over 2½ to 3 years in that position, and we have a good division of labor. Right now, for instance, Ms. Ross is working with the Secretary to brief one of your colleagues this afternoon on Customs funding issues.

Mr. HORN. One of the things that concerns me, and I said that to Mr. Munoz when he held that job, is that to me and to the Congress on a bipartisan basis, we all agree that the CFO position is a full-time job, and you can't be Assistant Secretary for Management and also CFO. I don't know if the new Secretary is taking that into mind, but it just seems to me that one of the problems in Treasury has been that the CFO was part of the Assistant Secretary for Management and not a full-time CFO, and that is what Congress wanted.

If we had wanted to put it with the Assistant Secretary for Management, we would have written it into the law. That has been around since the Hoover Commission of the 1950's—late 1940's, early 1950's. But we just are not getting, I feel, the leadership there when you don't have somebody full-time that reports to the Secretary or the Deputy Secretary, as the case may be.

Mr. APP. I would say that the person that has held that job since I have been there, both Mr. Munoz and Ms. Killefer, and now Lisa Ross, do take their responsibilities very seriously. We have a strong deputy network as well, and I think the progress that we have made on financial management over the last 4 years that I have been in Treasury shows that commitment and it really does come from that leadership. The division of labor is such that we do cover all of the bases, I believe.

Mr. HORN. Well, but a CFO in other agencies is full-time. I mean, let's face it, the Assistant Secretary for Management has a lot to do without having the CFO burden put on top of that.

As I recall in your resume, Mr. Rogers, it says you are Senior Adviser to the Assistant Secretary for Management and acting CFO. In the case of the Internal Revenue Service, won't you agree that given the current financial management problems facing IRS, that the CFO position ought to be a full-time job?

Mr. ROGERS. Well, yes, sir, and I will assure you that in the time I have been here, it has been full-time. While I hold the other position, I am on loan full-time for IRS, and that is the only thing I am working on.

Mr. HORN. Well, I just feel at the Treasury level, IRS level, we want persons absolutely totally focused. Those are 18-hour jobs a day, we know that, and it is 6 days a week. Anybody in that kind of level. It is just not doing the CFO job, no matter how they might seem to paint it, but the other agencies that have come from zero into fairly good shape nowadays, they are full-time CFO.

And I would hope Secretary Summers understands that, but maybe he doesn't. Maybe we need to write him a letter to remind him or something.

Does GAO have any remarks on this?

Mr. KUTZ. I would say GAO has been very pleased with the work Mr. Rogers has done in the short period of time he has been there. He has demonstrated a tremendous amount of ability as a manager and someone who can get things done. So we are very encouraged by what he has done.

I will say that right now the organization of the CFO within the IRS is a problem. The CFO is three levels below the Commissioner and is more of a controller position, if you think of the corporate model, than it is a CFO. So one of the issues on that we have had—and the Comptroller General spoke directly to the Commissioner of the IRS on this was that that position needs to be elevated and given more clout and more responsibility to try to make sure that some of these issues get resolved.

Mr. HORN. Well, I noticed that when I looked at your organization chart here, the mess under previous years where everybody sort of was all over the place; but I didn't see the CFO reporting to the Commissioner.

Mr. KUTZ. No. Way, way below that level.

Mr. HORN. It should. Well, I couldn't tell from the source where the level was. That was the problem. I have forgotten now the page it is on, but here we are. It is the new organization structure—struggle is right. That is a Freudian slip.

Page 41—page 42 and page 41, presumably it says, exhibit 2, current organization structure, is Commissioner; Deputy Commissioner, Operations; Deputy Commissioner, Modernization; and so forth. Well, the Commissioner has turned that completely around, right, and this is the new organization structure on exhibit 3 where you have Deputy Commissioner—Commissioner, Deputy Commissioner, and then a national office staff, which has finance there somewhere, who—although we can't quite tell where. And the Chief Counsel reports directly to the Commissioner and the Deputy Commissioner, but there is no word that the principal finance or management officer or, the CFO and the CIO—Congress, after listening to your fine GAO reports for years said. Hey, we have to do something about this. So we have to get a line where the people can have access to the person the President is holding responsible for the agency, which is the Commissioner.

Mr. KUTZ. And a key to involving these problems is to have a strong manager like Mr. Rogers in the appropriate position within the organization, to have the clout to make the kind of changes that need to be made to get these problems resolved.

Mr. HORN. Well, I agree with you. So have we written Mr. Rossotti that?

Mr. KUTZ. We have not written him. The Comptroller General told him face-to-face.

Mr. HORN. OK. Well, that is good. I will do it either way. Great. Both.

Anyhow, we thank you all for coming up here. It has been very helpful. We will send a few questions just for the record so it is rounded out, but I don't want to take your time today.

Good luck, Mr. Rogers and Mr. App, you are all doing a fine job; and the GAO always does a fine job. So thank you very much, gentlemen.

To the clerk, we will note that I want to thank the following people Russell George, staff director and chief counsel; Louise DiBenedetto, the detailee counsel here for this hearing from GAO; Bonnie Heald, director of communications; Bryan Sisk, clerk for the subcommittee. Minority staff, Trey Henderson, counsel; Jean Gosa, minority staff assistant; and the court reporter is Julie Bryan.

With that, we are closed.

[Whereupon, at 1:55 p.m., the subcommittee was adjourned.]

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